SFML Quarterly Newsletter
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June 2018

In this quarterly edition, we review performance and attribution for the quarter. We revisit the notion of investing ahead of the curve, we introduce Nanosonics to the portfolio, we review the once in a lifetime Reece acquisition, we visit Japan and comment on China. Image: We salute Cliff Young who simply focused on the long run.

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selector

About Selector

We are a boutique fund manager with a combined experience of over 150 years. We believe in long-term wealth creation and building lasting relationships with our investors.

Our focus is stock selection. Our funds are high conviction, concentrated and index unaware. As a result, we have low turnover and produce tax effective returns.

We seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

Dear Investor,

The June quarter proved eventful, with strong macroeconomic data providing a positive backdrop for a continuation of sustained economic growth. This is most evident in the U.S. where the unemployment rate sits at an 18-year low of 3.8% and the U.S. Federal Reserve has seen the need to edge rates up, currently set in the 1.75%-2.00% range. Chairperson Jerome Powell put things into perspective, *"The main take away is that the economy is doing very well. Most people who want to find jobs are finding them and unemployment and inflation are low. Growth is strong, labour markets are strong, inflation is close to the 2% target."*

While Powell's comments are reassuring, investors should avoid complacency. The ongoing tariff debate is illustrative of potential political missteps, a situation that is becoming far too common both locally and abroad. Fortunately, businesses get on with things despite the plethora of obstacles that are invariably thrown in their path.

On that score, many company executives are doing just that, with the focus now extending further afield as international opportunities open up. This was evident in January when global slots manufacturer Aristocrat Leisure undertook a US$990m acquisition of social gaming company Big Fish to further complement its earlier moves into this growing category.

During the June quarter another two of our portfolio holdings, namely plumbing operators Reece Group and Reliance Worldwide Corporation each paid $1.9b and $1.2b respectively in acquiring the operations of Morsco in the U.S. and John Guest in the U.K. In this quarterly we explore one of these deals, as we consider Reece's move into the U.S.

We follow this up with a deeper dive into a new business that has made its way into the portfolio, global infection prevention company Nanosonics. We also provide feedback on our travels offshore during May, as we visited the Japanese and European operations of pizza franchisee operator Domino's Pizza Enterprises. Finally, we take a closer look at China and its rise as a powerful economic force.

For the June quarter, the Fund delivered a gross positive return of **10.35%** compared to the All Ordinaries Accumulation Index which posted a gain of **8.03%**. For the financial year the Fund delivered a gross positive return of **33.78%** compared to the All Ordinaries Accumulation Index which has posted a gain of **13.73%**.

We trust you find the report informative.

Regards,

Selector Investment Team

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Quote: Michael Cameron ex-GPT CEO

"The best way to anticipate change in your sector is to spend some time outside of it."

When Michael Cameron was CEO of property group GPT, he sought outside assistance in considering how the world could change. His quote is even more relevant today, at a time when megatrends are disrupting all manner of industries. ***SFM***

Performance June 2018

For the quarter ending June 2018, the Fund delivered a gross positive return of **10.35%** as compared with the **8.03%** rise in the All Ordinaries Accumulation Index.

Performance table since inception

Returns	Gross Fund Return (%)	All Ordinaries Accumulation Index (%)	All Ordinaries Index (%)
3 Months	10.35	8.03	7.17
6 Months	16.10	4.04	1.98
1 Year	33.78	13.73	9.12
3 Years annualised	22.24	9.48	4.88
5 Years annualised	21.47	10.28	5.66
10 Years annualised	15.11	6.16	1.66
Since Inception annualised	13.56	8.25	3.78
Since Inception cumulative	468.92	195.66	66.12

Fund's Top 10 holdings

Top 10 June 2018	Top 10 March 2018
ARISTOCRAT LEISURE	ALTIUM
ALTIUM	ARISTOCRAT LEISURE
CSL	COCHLEAR
FLIGHT CENTRE TRAVEL GROUP	CSL
JUMBO INTERACTIVE	FLIGHT CENTRE TRAVEL GROUP
OIL SEARCH	JUMBO INTERACTIVE
REECE	NIB HOLDINGS
RELIANCE WORLDWIDE	RELIANCE WORLDWIDE
RESMED	RESMED
SEEK	SEEK
Top 10: 49.06%	**Top 10: 43.08%**

* *Listed in alphabetical order*

Selector employs a high conviction, index unaware, stock selection investment strategy, which typically targets 15-25 stocks for the Fund. As shown above, the Fund's top 10 positions usually represent a high percentage of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average "run-of-the-mill index hugging" fund manager. Our goal remains focused on truly differentiated broad-cap businesses rather than the closet index hugging portfolios offered by most large fund managers.

ASX Sector Performance – June 2018 Quarter

S&P ASX Industry Sectors	June 2018 Quarter Performance (%)
ENERGY	19.65
HEALTH CARE	16.40
CONSUMER STAPLES	11.88
MATERIALS	11.55
INFORMATION TECHNOLOGY	10.88
CONSUMER DISCRETIONARY	10.34
INDUSTRIALS	4.23
FINANCIALS	2.28
TELECOMMUNICATIONS	-13.68

Portfolio contributions

June 2018 Quarter

Top 5 contributors	%	Top 5 detractors	%
ARISTOCRAT LEISURE	2.04	AINSWORTH GAME TECHNOLOGY	-0.78
RELIANCE WORLDWIDE CORPORATION	1.11	TECHNOLOGY ONE	-0.58
CSL	0.89	IMPEDIMED	-0.42
JUMBO INTERACTIVE	0.86	NIB HOLDINGS	-0.33
OIL SEARCH	0.78	IOOF HOLDINGS	-0.32

June 2018 Financial Year

Top 5 stock contributors	%	Top 5 stock detractors	%
ALTIUM	6.98	AINSWORTH GAME TECHNOLOGY	-1.11
JUMBO INTERACTIVE	2.69	TECHNOLOGY ONE	-0.96
ARISTOCRAT LEISURE	2.59	IMPEDIMED	-0.41
FLIGHT CENTRE TRAVEL GROUP	2.06	MYOB GROUP	-0.30
RELIANCE WORLDWIDE CORPORATION	1.92	NAVITAS	-0.07

Top Contributors

1. Aristocrat Leisure (ASX:ALL)

During May Aristocrat Leisure delivered their interim results for the six months to March 2018. Earnings per share before goodwill amortisation rose 33% to 56.6 cents benefitting from both the inorganic growth of acquisitions and an outstanding result in the U.S. gaming operations division. Revenue rose 33%, and operating earnings grew 29%. An intense focus on product development is paying dividends. Top performing content and hardware has led to market share gains in the U.S. gaming operations division. Although market share growth in this segment will moderate, the company is well placed given competitors are either maintaining or scaling back their investments in product development. The largest driver of growth was the digital division, boosted by the acquisitions of online and social game developers, Big Fish and Plarium. An important consideration for the digital segment is the company's ability to leverage game development from their traditional businesses through digital channels, giving it a substantial competitive edge over smaller competitors.

Aristocrat has a market capitalisation of $19.5b and net debt of $2.6b, up from $0.7b last September following the recent acquisitions.

2. Reliance Worldwide Corporation (ASX:RWC)

Behind-the-wall plumbing fittings manufacturer Reliance Worldwide Corporation made a transformational acquisition during the period, agreeing to purchase John Guest Holdings for £867.5m ($1.22b). John Guest is headquartered in the U.K. and is also focused on the behind-the-wall plumbing market, leading the world in plastic push-to-connect (PTC) fittings. Throughout Europe, where water pressures tend to be lower than Australia and the U.S., plastic PTC fittings are favoured over brass. In comparison, Reliance is the global leader in brass push-to-connect fittings and has an extensive distribution network throughout North America and Australia but has almost no exposure to Europe. Reliance had been evaluating, for some time, the best way to expand their presence in Europe. Through John Guest, they have acquired a business that is complementary from both a product and geographic distribution point of view.

Both Reliance and John Guest are growing as they convince plumbers to change their practices and stop using fiddly, time-consuming methods to join copper and PVC pipes. While there are some cost savings to be made early on by rationalising facilities in the U.K. where both companies have a presence, there are more material opportunities to open up new markets such as combining plastic PTC fittings with valves manufactured by Reliance into integrated units. John Guest also has products in the water filtration and control market which can be rolled out by Reliance in the U.S., expanding their addressable market.

With a market capitalisation of approximately $2.2b and net debt of $240m prior to the acquisition, the company looked to existing shareholders to fund an institutional raising of approximately $945m. The purchase is obviously not without risks, particularly given the size of the transaction. However, the consistency of the strategies of the two businesses and the immediate exposure to Europe that John Guest will afford Reliance ameliorated most investors' concerns.

Reliance now has a market capitalisation of $4.3b and post close of the acquisition will have net debt of approximately $550m (~2.3x operating earnings).

3. CSL (ASX:CSL)

Global biotherapeutics company CSL lifted their earnings outlook for the 2018 financial year from US$1,680m to US$1,710m compared with earlier guidance of US$1,550m to US$1,600m. The improved earnings were driven by a strong northern hemisphere flu season, positive sales mix shifts and a delay in the launch of a number of key clinical trials. More importantly for the long-term outlook, the company is continuing to invest in the development of new products as well as expanding the indications current products can be used for.

CSL has been able to deliver shareholders strong earnings growth as new products and treatments drive higher revenue, without requiring a commensurate increase in the marginal cost of goods sold. The company owns the world's largest, most efficient blood plasma collection network, providing it with a reliable source of blood plasma, even during periods when competitors suffer from plasma shortages. As a supplier of treatments for life threatening medical conditions, the ability to reliably meet end users' demand is one of the key competitive advantages CSL holds over its competitors.

CSL has a market capitalisation of $89.8b and net debt of $3.6b.

4. Jumbo Interactive (ASX:JIN)

Online lotteries retailer Jumbo Interactive released a trading update for the 2018 financial year in early June, calling out a 25% increase in total transaction value. Higher transaction volumes were driven by a combination of customer database growth as more lotteries players move to online channels as well as a successful re-engagement of previously inactive customers. Revenue is expected to rise 22% which will see net profit come in at $11.0m, up 45% compared with the normalised profit earned in 2017. Jackpot activity was largely unchanged compared with the prior year. Future periods are expected to benefit from adjustments to the popular Powerball game odds which will lead to larger jackpot pools. The company also announced plans to pay a special dividend of 8c per share, returning to shareholders some of the cash from its current war chest.

Lotteries operator Tabcorp also exercised their option to purchase 3.5m Jumbo shares at $2.37 and simultaneously sold 2.9m shares to institutional investors. Tabcorp described their 12.49% holding in the company as strategically important.

Jumbo Interactive has a market capitalisation of $263.6m and net cash of $34m.

5. Oil Search (ASX:OSH)

Oil Search Managing Director Peter Botten provided a trading update and production guidance at the company's Annual General Meeting in Port Moresby, Papua New Guinea on 11 May 2018. Production is expected to fall to between 23 and 26 million barrels of oil equivalent for the 2018 financial year following the emergency shutdown of facilities operated by both Oil Search and ExxonMobil in the wake of the magnitude 7 earthquake.

Although the lost production will impact this year's financials negatively, the speed with which the operators were able to restart production was impressive. Further, the minimal damage incurred to infrastructure is a validation of the quality of the assets the company has developed.

Prior to the shutdown, the ExxonMobil managed PNG LNG project has operated well above its nameplate capacity since coming onstream in 2014. The project has one of the lowest break-even oil prices which ensures the owners earn healthy cash returns on their investment, even in a subdued price environment.

Oil Search also own a 22.8% share in Papua LNG which is expected to be one of the lowest cost LNG projects globally when it comes online in 2023. Papua LNG will have improved economics due to resource quality and proximity to LNG buyers. The project will be developed as a brownfield expansion of the existing project, dramatically reducing the capital costs of the development.

We visited the company in PNG shortly after the earthquake hit the highlands and our trip confirmed that discussions and planning for the brownfield development of an additional three LNG trains are on track. The trip also gave us insight into the extent of community engagement Oil Search undertakes, especially in remote regions, where the government is unable to provide even basic services. The company's ability to manage community relations is undoubtedly one of the reasons they have been so successful in PNG.

Oil Search has a market capitalisation of US$9.95b and net debt of US$2.7b.

Bottom Contributors

1. Ainsworth Game Technology (ASX:AGI)

Ainsworth released a trading update during the quarter outlining a product release issue which would see earnings in the second half fall far short of expectations. Previously, the company had expected to deliver profit before tax of more than $42m for the half, but the update outlined that the result would come in closer to $20m. The key to delivering better operational performance is investment in product development and while we can see the improvements Ainsworth has made, the update reduced our confidence that the Ainsworth business has sufficient scale to compete with the likes of Aristocrat Leisure. Our decreased confidence led us to close out our position and redeploy the funds into other opportunities.

2. Technology One (ASX:TNE)

During the period enterprise software services provider Technology One delivered their interim results for the six months to March 2018, with profit before tax falling just short of market expectations. The company tends to have a high degree of seasonality and generates the bulk of its profit in the second half. Weak cash flow gave investors cause for concern as did the impact of upcoming changes to accounting standards but it appears these factors are transitory and will be addressed in future periods. Looking through these issues we see a company with a compelling customer value proposition, a strong growth pipeline and limited competitors.

Post the end of the quarter, management hosted briefings with investors to explain the upcoming implementation of new accounting standards for revenue recognition. The company will report less revenue in the 2019 financial year than they would have reported under the current recognition policy. Management have also decided to capitalise between 40% and 60% of R&D expenses. The upshot of the changes is there will be minimal impact on reported income and cash flow will be unchanged.

Technology One has a market capitalisation of $1.5b and net cash of $57m.

3. Impedimed (ASX:IPD)

The last six months has seen bioimpedance spectroscopy (BIS) specialist Impedimed, deliver a number of key milestones. The company has had its SOZO device approved for the monitoring of extra cellular fluid in Chronic Heart Failure patients, as well as for the assessment of at risk bilateral lymphoedema patients. The approval for bilateral lymphoedema patients almost quadruples the size of the addressable market for Impedimed in the lymphoedema space. The company also announced full enrolment of the PREVENT trial, designed to assess the effectiveness of BIS in identifying breast cancer related lymphoedema (BCRL) compared with the current standard of care.

During the most recent quarter, the results of an interim analysis conducted on the first 500 patients involved in the PREVENT trial were released. Although details were limited, they appear to show a substantial improvement in the ability of BIS to detect BCRL early, thereby preventing progression to the more serious stages of the disease. More details will be released in upcoming industry publications. This data, once published in a peer reviewed article and combined with the results from numerous recently completed independent studies, will make for a convincing argument to private payers (insurers) that patients covered under private health care schemes in the U.S. should receive reimbursement for monitoring using BIS.

Impedimed has a market capitalisation of $169m and net cash of $37m.

4. NIB Holdings (ASX:NHF)

NIB Holdings was weak during the period as investors digested the risks of a potential Labor government and APRA’s review of private health insurance capital standards. The concerns are largely an overreaction. Although the prospects for the private health insurance market sound bleak should the Labor party be elected, the threats made by its leader Bill Shorten reveal a poor understanding of the drivers of the cost of health care. In the event that Labor were elected, the prospects of legislation capping premium inflation passing parliament would still be low.

5. IOOF Holdings (ASX:IFL)

Wealth management specialist IOOF Holdings announced the acquisition of Australia and New Zealand Banking Group's (ANZ) Wealth Management business in October of 2017 for total cash consideration of $975m. ANZ's original desire was to dispose of its life insurance and wealth management business as one unit, however, the difficulty in finding a suitable buyer necessitated a sale of the businesses as separate units. Long standing IOOF CEO Chris

Kelaher clearly outlined how attractive the deal was: “I am extremely confident that this transaction will deliver superior outcomes for our clients, advisers and shareholders.”

The transaction will be the largest that the group has undertaken since listing, as well as the most complex. In terms of scale, funds under advice (FUAdvice) will rise by 34% to $77b, funds under administration (FUAdmin) by 125% to $83.8b, funds under management by 115% to $44b and the total number of advisors will increase by 71% to 1,734. This significantly increases the group’s scale and is highly complementary.

Sentiment has adversely affected wealth managers of all shapes and sizes through the ongoing Royal Commission into Misconduct in the Financial Services Industry. After having recently experienced its own very public compliance issues, IOOF has spent a considerable amount of time and effort improving its systems and processes. In addition, when compared to the likes of the bank owned wealth managers, IOOF’s “open architecture” gives advisors the ability to place their clients in whatever product they deem most suitable, rather than being forced to invest their client’s funds in IOOF owned products. This conflict of interest at bank owned wealth managers is one that has been under close scrutiny during the Royal Commission.

Tipping point?

Telstra CEO Andy Penn's June Investor Day message was crystal clear, *"Our legacy is now holding us back. It is time to take a bolder step and leave the past behind. We are at a point where we have to let the old world go. We are at a tipping point."*

For Telstra shareholders, of which we are not one, there is something quite frightening in what Penn is portraying. In truth, this reflects modern-day business. The pace of change is increasing and the threats to traditional business models are widespread. Company boards, management teams and even shareholders can no longer ignore the obvious. Bunkering down is no longer an option. Fortune will favour those investing ahead of the curve while adapting to an increasingly competitive, technologically driven world.

Investors also have to adapt. Our main share market index, the basis upon which many fund managers construct their portfolios has the four big banks hogging positions inside the top ten, alongside the resource twins BHP Billiton and Rio Tinto, as well Wesfarmers and Woolworths. Telstra no longer makes the grade. Its market value has dropped from $73b in May 2015, to $32b.

The notion that you can stick to a strategy of investing in an index or an investment philosophy which favours "value" over "growth", or vice-versa misses the mark in our opinion. While there appears to be a whole lot of value on offer in Telstra and the banks, competitive dynamics are whittling away the attractive margins they once enjoyed. The critical piece that needs to be focused on is not how a business appears today but how well it is positioned for the future.

While all businesses have their issues, market leadership is no longer a defensive barrier in itself. Adapting, investing, remaining relevant and agile are the attributes of today's industry leaders. On that score, Telstra has struggled, partly because the regulatory environment has removed the protection it once enjoyed. Faster, nimbler players without costly overheads are aggressively taking share and forcing change. The banks are in a similar position.

All are now discarding less desirable assets and operations in their pursuit of more defensible revenue streams. Penn has been forced to act at a time when the financial and personnel outcomes are less than desirable. Rationalising one quarter of the workforce is not great for internal morale, placing enormous cultural pressures on the business. Having openly acknowledged that the *"old world"* has to go, the real question now is whether Telstra can truly adapt to the new world. From what we have seen so far, we struggle to form a positive view. ***SFM***

Reece

The word transformational is often used by management teams to describe an important event or action. In business, it is often linked with big acquisitions, accompanied by significant debt and strategic risk. These are words one would not associate with Australia's biggest plumbing group, Reece.

Listed on the Australian Stock Exchange in 1954, the firm has grown from two outlets in 1969 to its present-day tally of over 600 stores throughout Australia and New Zealand. The company's progress has been both consistent and impressive, a testament to the management team at Reece and its major shareholders, the Wilson family. We profiled the business in our March 2014 Quarterly Newsletter and today it remains a significant investment within our portfolio.

On 7 May 2018, Reece unveiled what many had not expected, a strategically significant expansion into one of the world's biggest markets, the U.S. The move was accompanied by an equally significant debt and equity raising. In explaining the deal, CEO Peter Wilson described the acquisition of leading plumbing, waterworks and heating, ventilation and air conditioning (HVAC) equipment distributor Morsco as follows, *"This is definitely a historic opportunity for Reece and really is a transformational opportunity in many respects, a once in a lifetime opportunity."*

It's easy for management teams led by investment bankers to speak glowingly of big deals, but at times there are exceptions. It would appear on the limited evidence thus far, Reece has taken a bold but well considered move. The step appears well founded and consistent with the company's core competency and business philosophy.

The deal

The $1.9b purchase from private equity group Advent International is significant on multiple fronts. Firstly, it represents the company's biggest international move. Secondly, the expansion has been partly funded by the issue of new shareholder equity, the first time the company has ever called on shareholders since listing, a period spanning some 64 years.

All up, new capital of $600m was provided by both existing and new investors. The Wilson Family, representing 76% of the register, put their hand up for $300m of new shares, thereby maintaining an interest of 73% in the company. The balance of the $1.3b purchase, made up of new debt, will leave the group with a gearing ratio (net debt to EBITDA) of 2.8x.

Morsco

The Morsco business is well established and a leading player in the key markets of plumbing, waterworks and HVAC. The group is based in the south of the U.S. operating across 16 States and turns over US$1,716m, generating operating profits of US$100m. As a combined group, Reece will be turning over A$4.8b of revenue and operating profits of A$505m.

Wilson noted the company has long held desires to expand into the U.S. Reece's management were first introduced to Morsco in 2013, and discussions became more serious in 2016 before leading to full and exclusive due diligence with the vendor Advent International in 2018. The significance of the deal is not lost on Wilson:

"When you consider we have had pretty humble beginnings but to think today that we are acquiring the number four plumbing wholesaler in the U.S., the number three waterworks wholesaler and when you combine those two with the Reece Group you get a combined company with revenues circa A$4.8b. Quite a historic day for us.

This is definitely a unique opportunity for long-term growth. We are looking at this from a very, very long-term perspective. Morsco really is a strategic platform across the sun-belt States, so they are the growth states of the U.S. But what we really like is that it gives us access to the biggest plumbing market, the biggest waterworks market and the biggest HVAC market in the world and those markets are growing at double the rate of the corresponding markets are here."

Some background

Morsco is the parent company of Morrison Supply Company. The business was founded in 1917 as the Fort Worth Pump & Windmill Company in Texas, before renaming itself in 1926, in recognition of the elderly J.T. Morrison's leadership. Throughout the course of nine decades, Morrison Supply extended its footprint into Oklahoma, Kansas, Louisiana and New Mexico with over 70 locations to serve local contractors. Morrison had become the strongest independent plumbing supply company in the U.S. southern sun-belt.

In November 2011, Morrison received a significant equity investment from Advent International, one of the world's largest private equity firms. Morrison's management retained a significant ownership position while Chip Hornsby, a 40-year industry veteran, joined Morrison as CEO, embarking on a new phase of expansion. As Wilson described the then partnership, *"Chip provided the brains, Advent the capital".*

From 2012 onwards, under the leadership of Hornsby, Morsco undertook a series of acquisitions. First, by adding 13 new locations in southern California with the acquisitions of Express Pipe & Supply and shortly thereafter, Teal Supply. In September 2013, Morsco acquired Farnsworth Wholesale Company, the largest independent player in Arizona with seven locations in the greater Phoenix and Tucson markets.

Morsco solidified its position when it acquired Wholesale Specialties in February 2014. Further expanding in the southeast in September 2015 with the acquisition of Murray Supply Company and their eight locations, before adding Atlanta-based Devore and Johnson in May 2016. In October 2016, Morsco expanded its footprint throughout the sun-belt by acquiring Fortiline Waterworks, one of the largest waterworks distributors in the United States.

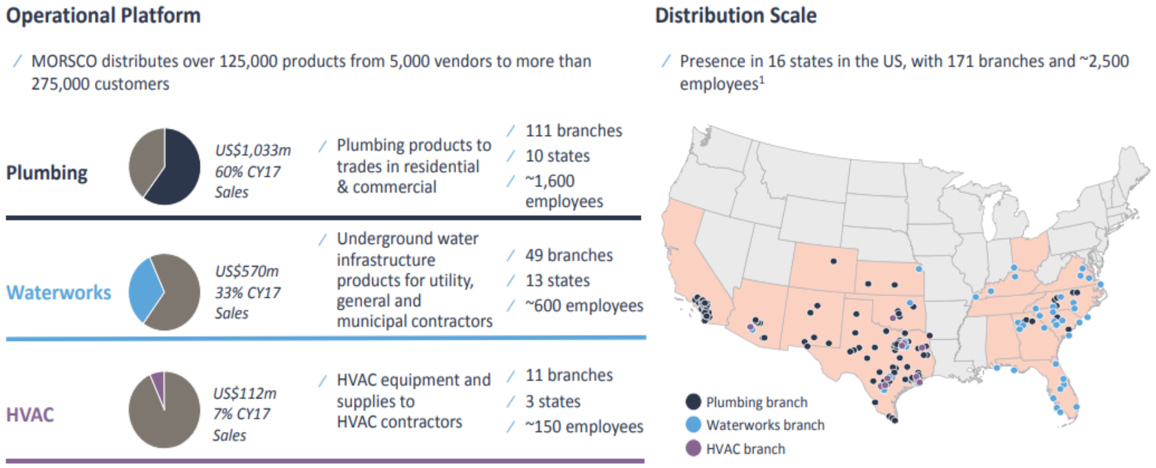
Morsco's aim

"Our goal was to become the nation's leading plumbing and HVAC distributor with luxury showrooms by focusing on people – best service for our customers and best place to work. We planned to do this by assembling the very best regional businesses and people in our industry,

focusing on the most attractive local markets in the country and servicing our customers with the best people at the local level."

While acknowledging the inherent risk in any acquisition, Reece management have undertaken extensive due diligence on an exclusive basis. Under Reece's ownership, Morsco will be managed independently of the main Australian operations, with current CEO Chip Hornsby continuing in his role, supported by the key executive team.

Figure 1: MORSCO Operations



Source: Reece Group – Acquisition of Morsco and Capital Raising Presentation

Morsco services three distinct markets:

1. Plumbing, with revenue of US$1b, representing 60% of sales.
2. Waterworks, with revenues of US$570m, 33% of group sales.
3. Finally, HVAC, with revenue of US$112m or 7% of total sales.

Figure 2: MORSCO market positioning and growth

Source: Reece Group – Acquisition of Morsco and Capital Raising Presentation

The big opportunity

The business' geographical focus remains the sun-belt region of the U.S. with a strategic pursuit to grow both organically and via acquisitions. Wilson expands on this point:

"But fundamentally the part I guess that excites us the most is the opportunity for growth. And that opportunity is in an organic sense and also from an acquisition perspective. The U.S. market is very fragmented, it is not like here, and the scale of the place is phenomenal and largely plumbing is dominated by these family businesses, that's the nature of trade businesses. We have done the consolidation in this country over the last 20-30 years.

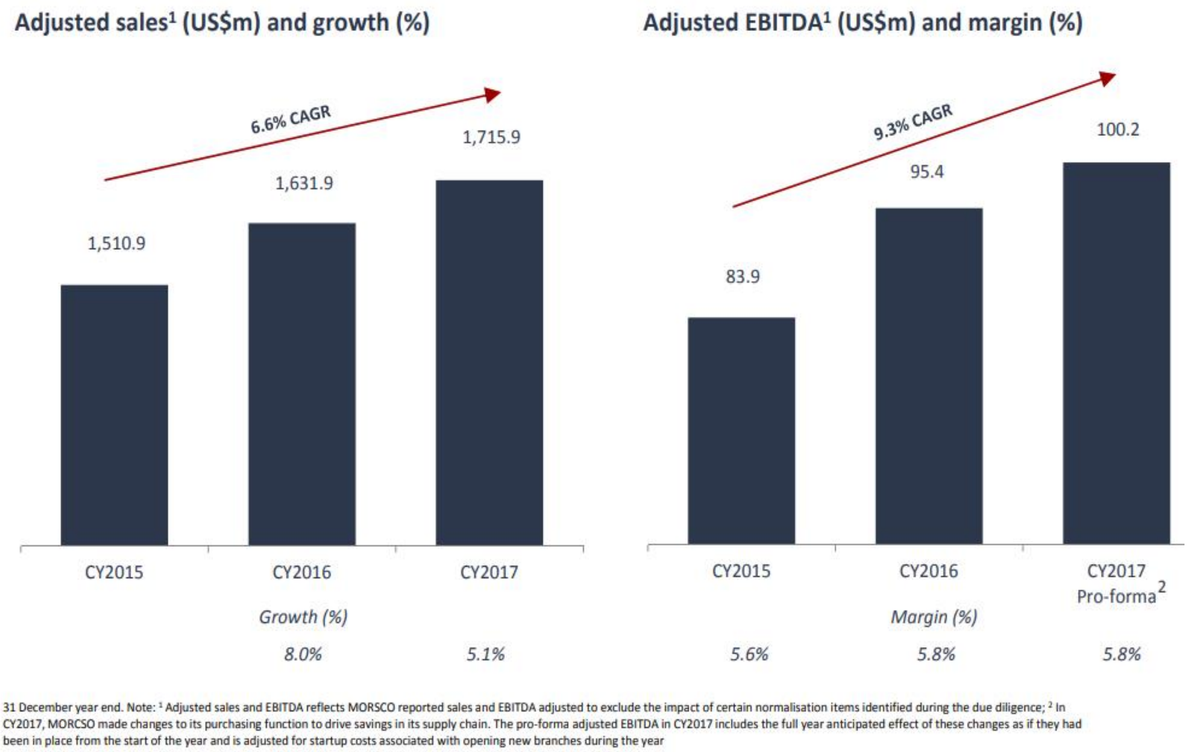
Just to put some context into that opportunity, Texas is where the head office of Morsco is located. That was the foundation acquisition. Morsco was started by acquiring the equal number one or close number two plumbing wholesaler in Texas, a family business, and that's why they put the head office in there.

Texas, with a population bigger than Australia, is adding 400,000 people per year and has an unemployment rate at 2%. It is unbelievably pro-business and has no state or income taxes. The infrastructure is quite amazing. And to make the comparison, Morrison which is the foundation part has 75 plumbing stores in Texas, Reece in Australia for a smaller population has 375 plumbing stores. That's just Texas."

Figure 3: MORSCO's management team

Source: Reece Group – Acquisition of Morsco and Capital Raising Presentation

Figure 4: MORSCO sales and earnings growth

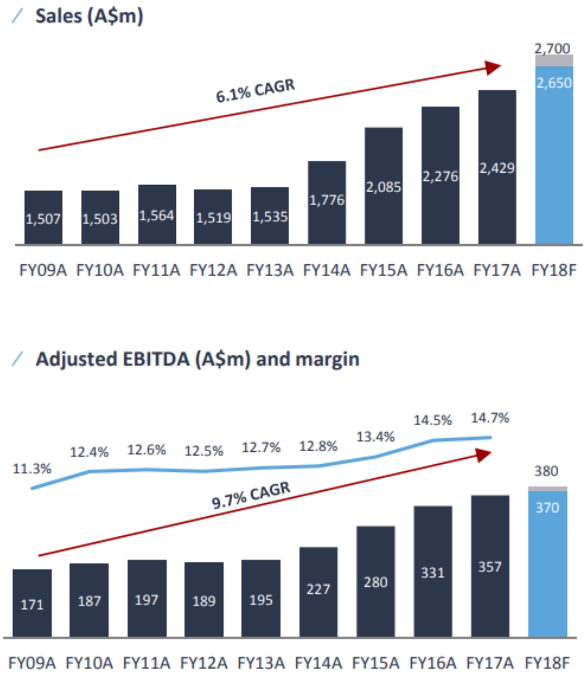


Source: Reece Group – Acquisition of Morsco and Capital Raising Presentation

Reece Group

As we have already outlined, the Reece business began in 1920, with the Wilson Family taking effective control in 1969. From that two-store beginning and with a market capitalisation of circa $400,000, the next 30 years saw management re-invest three-quarters of after-tax profits back into the business. An approach that very much epitomises the Wilson approach. One based on taking a long-term perspective with an unbelievable focus on the customer.

Figure 5: Reece Group historical financial performance and FY18 guidance



Record result expected to be delivered for FY18

- Opened 10 new branches plus the additional branches from the Viadux and Heatcraft NZ acquisitions
- Continuing to leverage supply chain to deliver market leading products and services
- Investment continues in the branch network to improve and deliver great customer service
- Enhanced online offering for both trade and retail customers

FY18 guidance[1]

Year ending 30 June 2018	A$m
Sales	2,650 – 2,700
EBITDA	370 – 380
NPAT	223 – 230

- New Shares issued on a pari passu basis and will be eligible for the 2H FY18 dividend, which will be no less than 2H FY17 on a split adjusted per share basis

Note: [1] FY18 guidance range has been prepared based on Reece's nine month trading to 31 March 2018 and consideration of the budget performance for the remaining three months of FY18. The guidance has been provided as a result of the transaction and does not indicate an intention for Reece to provide similar guidance going forward.

Source: Reece Group – Acquisition of Morsco and capital raising presentation

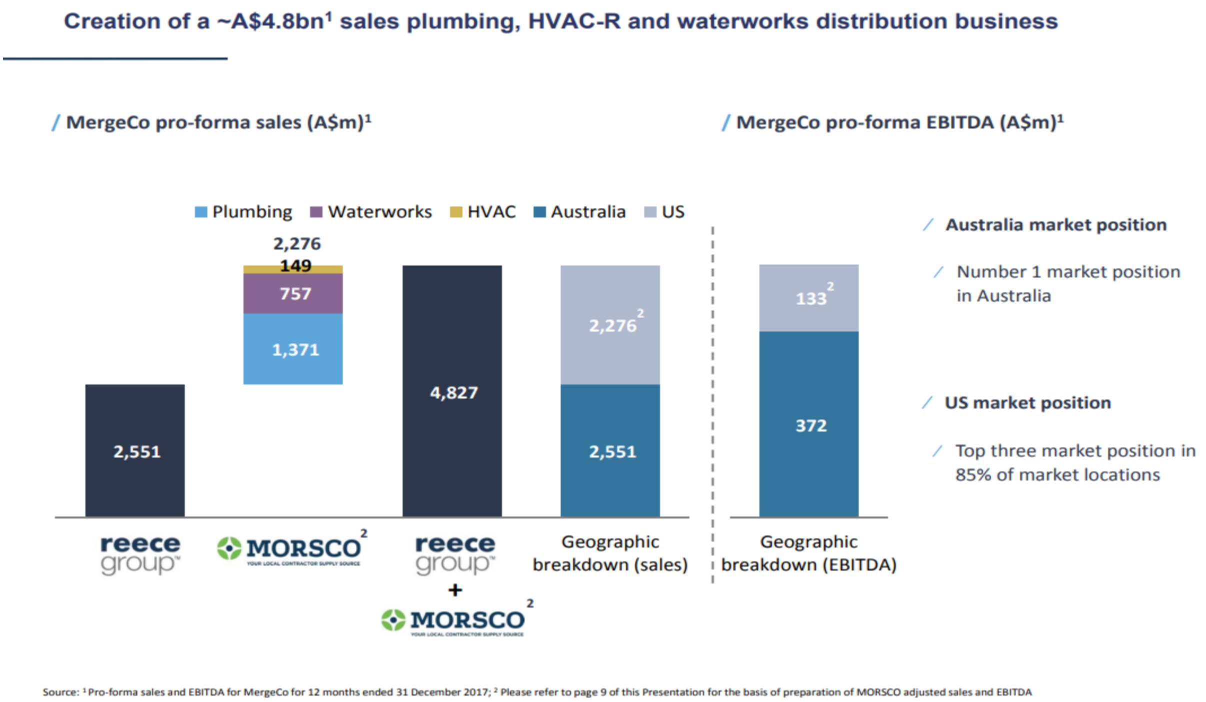
Reece – More than a plumbing company

Today, the company is number one in plumbing and bathrooms, number one in HVAC and refrigeration and a leader in waterworks. Wilson attributes this success to the many strengths within the business, preferring to describe it as a:

1. *Marketing company* – achieving a Net Promoter Score (NPS) of +64, the highest of any trade business in the country. Also brought in-house the creative trading agency, employing over 40 internal designers.
2. *Services organisation* – a culture that puts the customer first.
3. *Trading company* – employs a unique pricing and selling model, leading to the highest margins in the industry.
4. *Logistics and supply chain company* – over the past decade the business has become a full logistics company, having invested well more than $100m in modernising the supply chain, supplemented by big physical distribution centres (DCs). They have also developed an in-house stock management position with over 1,500 vehicles, able to deliver products within 2 hours. Selector has visited the Melbourne distribution centre and can attest to its scale and efficiency.

5. *Property company* – over 50% of stores are owned outright, a real competitive barrier to entry.
6. *Financial institution* – offers a credit facility to the plumbers.
7. *Software house (technology company)* – the core ERP is internally owned, its proprietary with a continuous improvement philosophy.

Figure 6: The merged company



Source: Reece Group – Acquisition of Morsco and Capital Raising Presentation

Summary

The Morsco purchase is transformational in nature and if management can execute effectively, the opportunity for the business is significant. More importantly, the company's propensity to stick to its core business, investing to drive long-term gains, is an approach that sits comfortably with us. ***SFM***

Nanosonics

Table 1: Nanosonics historical timeline 2001-2018

Date	Events
2001	Business founded, focused on commercialising disinfection and sterilisation products using proprietary technology.
2002	3M Corporation provides funding and technical support, ultimately holding 2.2% of Nanosonics equity upon listing.
2007	Company lists on the Australian Stock Exchange, issuing 54m shares, raising $27m, valuing the business at $92m.
2007	Founders, Maurice and Bernard Stang, control 54.7% of the equity.
2007	First sales of ultrasound disinfection product anticipated 2008, targeting strategic partnership with an Original Equipment Manufacturer.
2007	CEO Geoff Marshall steps down from the position, having been in the role for three years.
2008	Company awarded CE Mark approval for Ultrasound Disinfector device.
2008	David Radford appointed CEO, having held senior roles within GE Healthcare.
2008	Approval received from Health Canada to market and sell Ultrasound Probe Disinfector device.
2009	Australian Therapeutic Goods Administration (TGA) approves the company's Trophon EPR.
2009	Company reports first sales of Trophon EPR.
2009	U.S. Food and Drug Administration (FDA) application submitted. Prospective distribution partners estimate U.S. market at US$200m.
2009	Commences initial Trophon EPR launch into European markets with France.
2009	Company undertakes equity placement, raising $15.6m via the issue of 28.3m shares at an issue price of $0.55.
2010	Nanosonics signs an exclusive distribution agreement with GE Healthcare covering the U.S. and Canadian markets.
2011	Company outlines global opportunity, Australia $25m, Europe $280m, U.S. & Canada greater than 100,000 Trophon units.
2011	Company receives FDA 510k clearance to market Trophon EPR.
2011	CEO David Radford tender’s resignation.
2011	Current Director and acting CEO Dr Ronald Weinberger appointed as permanent CEO.
2012	Company undertakes new equity placement, issuing 29.2m shares at an issue price of $0.53, raising $15.5m, providing a cash balance of $20m.
2012	GE Healthcare invests $7.5m in Nanosonics through convertible notes with a 6% coupon and a $0.75 conversion price.
2012	Michael Kavanagh joins the Nanosonics board as non-executive director.
2013	U.S. based Scripps Health network selects Trophon EPR for product rollout.
2013	Toshiba Medical Systems signs as a non-exclusive distributor of Trophon EPR for the U.K. market.
2013	GE Healthcare and GE Ventures establish a dedicated Trophon EPR sales team to accelerate U.S. market rollout.
2013	Non-executive director Michael Kavanagh appointed CEO. Previous CEO Weinberger appointed President of Technology Development.
2013	South Korean regulator approves Trophon EPR.
2014	Company announces Trophon EPR approval for Japan.
2014	Company moves to new Lane Cove headquarters, the former global headquarters of bionic ear manufacturer Cochlear.
2015	Nanosonics announces the establishment of a direct sales operation in North America, alongside current partner GE Healthcare.
2015	Company announces the placement of 15.2m shares at $1.65 per share to raise $25m. Confirms North American installed base exceeds 4,000 units.
2015	A study by Society for Healthcare Epidemiology of America (SHEA) shows Trophon EPR is the only high-level disinfection system proven to kill human papillomavirus (HPV).

Source: Company announcements

Background

In our March 2011 Quarterly Newsletter, we provided an opinion piece called *“Lifting the lid on new stocks”* which covered six businesses. Within the article, we wrote: *“With a market* *capitalisation of $200m, Nanosonics appears to be on the cusp of moving from research and development concept to serious revenue generation. Its lead device is the Trophon EPR, an ultrasound probe sterilisation unit that was initially funded privately before interests associated with founders Maurie and Bernard Stang sought to take the business public in 2007."*

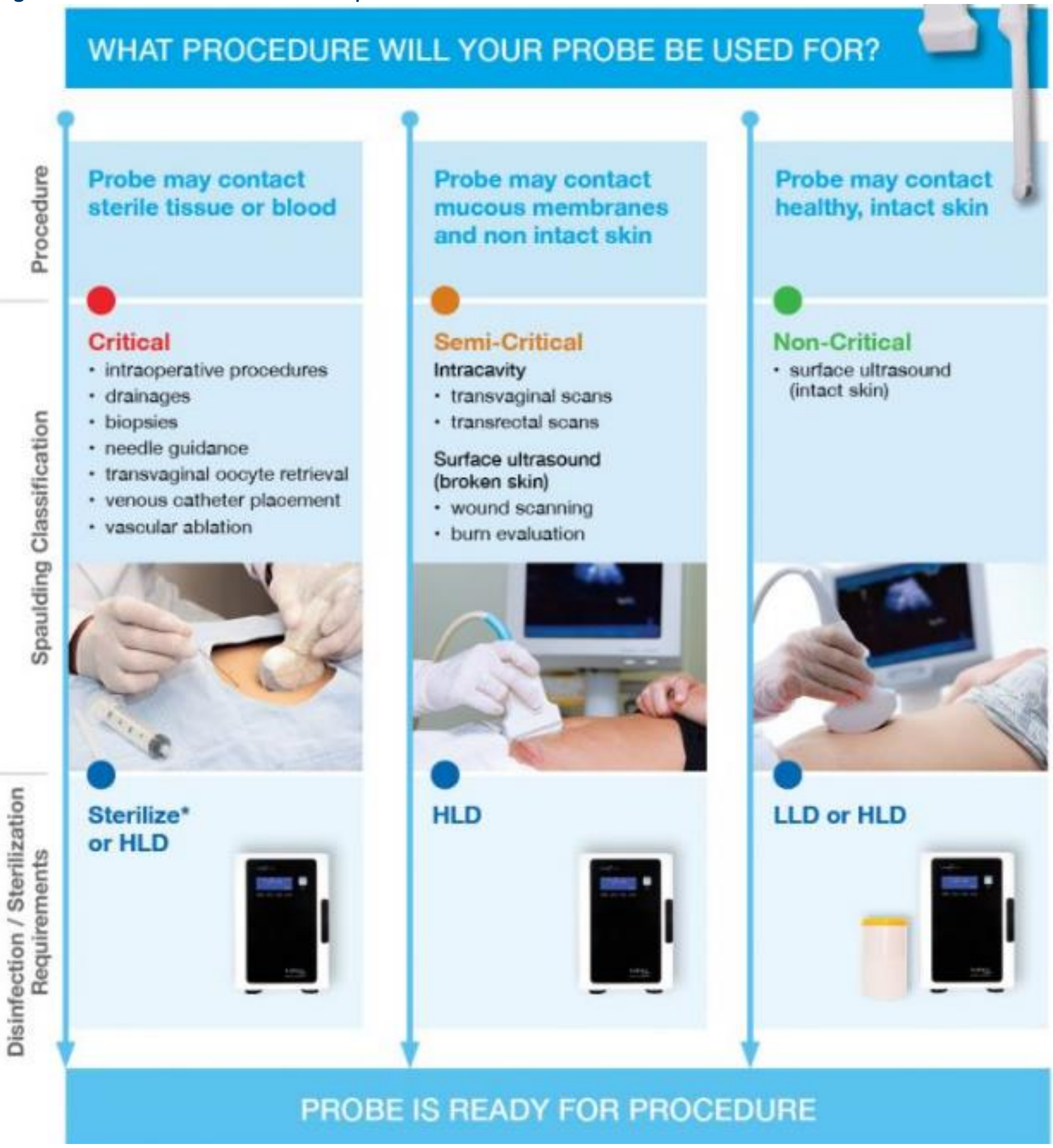
We have watched the company's progress since that time, noting that the valuation now exceeds $750m. Our reservation to act back then was predicated on two main issues. The first involved the ongoing need for new capital and the second concerned the exclusive reseller relationship the company had entered with GE Healthcare. These issues have now both been largely addressed. *Table 1* provides a timeline of company events since listing.

Business

The company describes itself as an *"innovator in infection prevention"*. Its lead product, the Trophon EPR, is a unique, automated high-level disinfection (HLD) device, used in the care of ultrasound probe disinfection practices. As outlined in the 2007 prospectus document, *"The company's high-level disinfection and sterilisation technology combines the powerful biocidal properties of formulated nanoparticles of hydrogen peroxide with proprietary delivery systems. The combination produces a cost-effective, near ambient temperature, low toxicity and rapid disinfection process."*

Today, the company employs over 165 staff, located across operations in Australia, the U.S., Canada and Europe. The group's lead product, the Trophon EPR has become the global standard of care for HLD of ultrasound transducers, while the business is now cash flow positive and profitable.

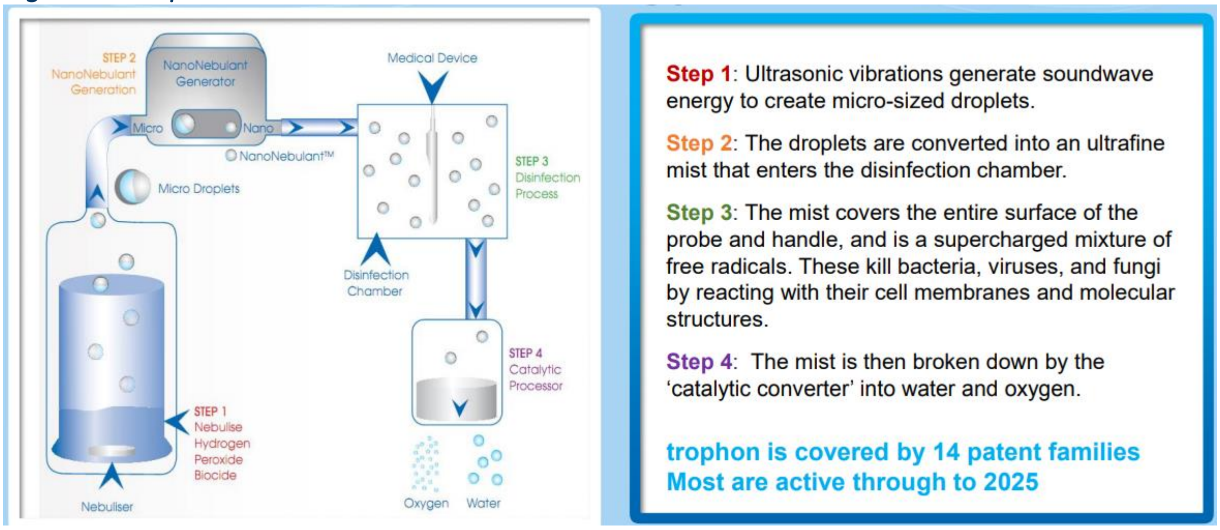
Figure 7: When to HLD with trophon



Source: Nanosonics website Platform technology

The company's platform technology is referred to as NanoNebulant, *"This is the process that uses high-frequency ultrasonic energy to nebulise (break up a liquid into a fine spray or aerosol) stabilised hydrogen peroxide to form active nanoparticles. This is applied to objects that need to be disinfected and deactivates the infectious agents or micro-organisms. The hydrogen peroxide aerosol is then converted into environmentally benign oxygen and water by-products."*

Figure 8: Trophon – how it works



Source: Nanosonics 2018 Half Year Results Investor Presentation

Initial products

The company has initially focused on what the industry terms *"semi-critical"* medical devices. These are medical instruments that require disinfection where possible. If sterilisation is not possible then (HLD) is required. A growing number of instruments are heat sensitive, meaning that traditional autoclaved disinfection processes cannot be used and as a result are submerged in toxic liquid chemistries such as glutaraldehyde. These chemicals pose risks to healthcare workers, damage medical instruments due to their corrosive impact and have adverse environmental consequences upon disposal.

Current disinfection and sterilisation practices include:

1. *Steam* – use of heat and pressure
2. *Liquid immersion* – toxic chemistries
3. *Gas* – hydrogen peroxide plasma

The development of Nanosonics NanoNebulant technology provided a breakthrough in sterilisation practices, that have been subsequently acknowledged by the major global health authorities including Europe's CE Mark in 2008, Canada Health also in 2008, the Australian Therapeutic Goods Administration (TGA) in 2009 and most importantly the U.S. Food and Drug Administration (FDA) in 2011.

The NanoNebulant technology has several advantages over existing technologies including:

1. *Low toxicity* – hydrogen peroxide properties are well known.
2. *Low-temperature disinfection* – compatible with most heat-sensitive instruments.
3. *One step* – disinfection of complete unit, encompassing handle and probe.
4. *Rapid process* – cycle times range from 3 to 15 minutes, compared to alternatives of 15 to 60 minutes.
5. *Cost effective* – the average 7-minute automated disinfection cycle process enables extra examinations to be undertaken.

6. *Environmentally acceptable* – waste reduced into oxygen and water.

The first product commercialised, the Trophon EPR, was specifically designed for HLD of ultrasound transducers. These are used in both intracavity and transcutaneous procedures. Since these probes can come into contact with bodily fluids, probes require disinfection between uses.

Figure 9: Trophon – the product

Source: Nanosonics 2018 Half Year Results Investor Presentation

Operation

The unit is highly versatile, in that it is available to be used at the point of care, alongside the ultrasound console. Importantly, the Trophon EPR works with all ultrasound companies, testing the system on their probes to validate their compatibility. To date, over 1,000 probes have been validated and are now compatible with the machine. To build a competitive product, a challenger would have to go through the same process to ensure all probes a hospital might use would be compatible.

The machine is simple to use. Rather than a 40-minute decontamination process under the old method, the sonographer opens the unit, hangs the probe in the cavity, closes the door, presses start and waits 7 minutes for the disinfection process to complete, with full digital traceability available. The main consumable product, a 100ml bottle of hydrogen peroxide, (H2O2), is inserted in the side of the Trophon EPR cabinet. It lasts for approximately 50 cleaning cycles, is patent protected and cannot be substituted.

Prospectus document

In the original prospectus document in 2007, the company’s initial focus with the NanoNebulant technology was on three devices:

1. Ultrasound probe disinfector
2. Automated endoscopic pre-processor

3. General purpose disinfector

In 2005 the global market size for disinfection and sterilisation systems was estimated at US$2b, with the company's offerings targeting segments worth A$600m for ultrasound and A$650m for the endoscope market.

Ultrasound market – the company estimated 550,000 ultrasound instruments were in use worldwide, with over 480m procedures carried out annually. Ultrasound manufacturing is dominated by global players Siemens, Philips and GE Healthcare, responsible for 65% market share, with the remaining market split between Toshiba, Hitachi, BK Ultrasound and Medison.

Endoscope market – the company estimated that over 10m endoscopic procedures were performed each year in the U.S. and over 60m worldwide. The main suppliers of equipment included Olympus, Pentax and Fujinon with market shares of 60%, 20% and 10% respectively.

The market opportunity

Management has since refined the ultrasound opportunity and determined that the global market comprise 120,000 units, broken into three regions, being North America, Europe and the Middle East and Asia Pacific. Each region represents about 40,000 units, with those numbers derived from the number of ultrasound units in place in each market.

Being a medical device, regulatory approval is required for the product's use. This has been received in all the major markets including Australia, New Zealand, U.S., Canada, Europe, Singapore, Hong Kong, South Korea and Japan. The company has a presence in these markets with the exception of South Korea.

From a competitive perspective, the Trophon EPR is viewed as the only successful automated unit in the market place. It has been shown to be safe and highly effective from a bacterial, fungal and viral side perspective as well as being safe for physicians since there is no exposure to chemicals and no residual impact on the environment.

Most importantly, the critical driver for market adoption is whether health guidelines require probes be high-level disinfected. In markets where guidelines recommend or require high-level disinfection, the adoption rate has been rapid. The U.S. is a case in point, where in a relatively short period, Trophon unit numbers have grown consistently to now total 14,100 units, approximately 35% of the potential market.

In Europe, the rollout has only just started, while in many other countries the guideline process is still in its infancy. That said, the past twelve months have seen a growing body of new regulatory guidelines introduced in countries including the U.K., France and Germany which have driven rapid adoption. In Japan the business is at the early stages of rollout while in the Australian market, which is the most mature, the company has been able to achieve 70% penetration, providing a valid proxy for what can be achieved in the right environment.

Figure 10: Regulatory path - guidelines

Source: Nanosonics 2018 Half Year Results Investor Presentation

Razor blade consumables model

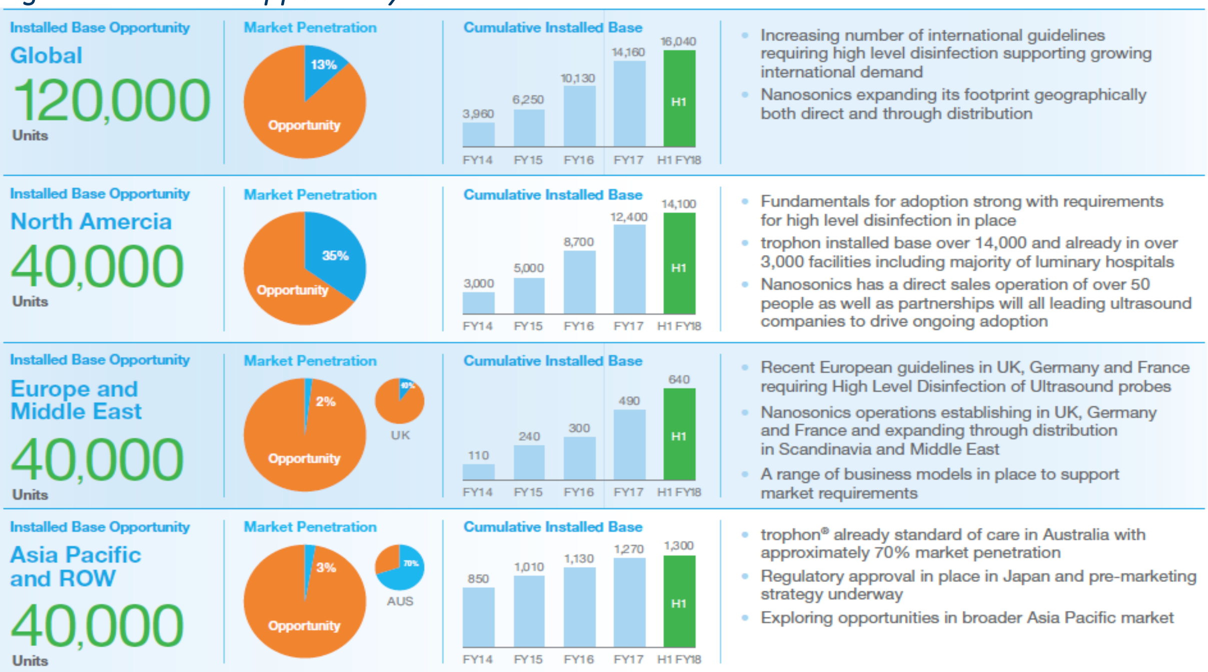
The company operates go-to-market models including a direct sales channel with a company employed sales representatives and a distributor model, utilising the services of the top players in the ultrasound market including GE Healthcare, Toshiba, Siemens, Philips and Japan's largest healthcare distribution operator Sakura Seiki. After the initial capital sale, disinfection cycle volumes see customers regularly purchasing disinfection consumables, chemical indicators and other components and parts.

Regarding the economics, Nanosonics sells the capital equipment for approximately $10,000-$15,000 at a gross margin of 65%. Each unit, in turn, requires annual consumables of roughly $3,000, providing consistent revenue streams, very similar to the razor and blade or printer and ink models. The global market opportunity, if fully penetrated, would total more than $1.2b, with recurring annual consumable revenues of $360m.

Figure 11: Trophon - the new standard of care

Source: Nanosonics 2018 Half Year Results Investor Presentation

Figure 12: Market Opportunity



Source: Nanosonics Investor Presentation – Wilsons Rapid Insights – May 2018

The go to market strategy utilised by the company varies according to the region. In the U.S., the company has adopted the more traditional model whereby the customer acquires the capital equipment either directly from the company or via a distributor and then continues to purchase the consumables on an as required basis. In the U.K., where National Health Scheme hospitals are capital constrained but can purchase services through their operating budgets, a model known as a Managed Equipment Service (MES) is offered. Under the MES scheme units are placed in the hospitals for zero upfront cost, but they roughly double the rate for the consumables, delivering far more profit to the company over the life of the unit, albeit with higher capital intensity. These models operate primarily where the business has a direct sales force, in the U.S., the U.K and now Germany.

Where distributors are used, there are two models. The first relates specifically to GE Healthcare who earns revenue from the capital sales as well as the ongoing consumable purchases. Under this arrangement, Nanosonics sell to GE Healthcare, who in turn sell to the customer. This results in GE Healthcare retaining the mark-up of the capital component as well as sharing in 50% of the consumables income, estimated at $1,500 per unit per annum. This relationship and the agreement that underpins it are set to change from 1 July 2019, with the total installed base of units in the U.S. to be directly serviced by the company instead of GE Healthcare. This will result in the total annual consumable spend per customer of $3,000 being retained by the company.

The second distribution model, referred to as a capital reseller model, allows the remaining resellers of ultrasound equipment to bundle the Trophon EPR with their own ultrasound equipment, with the units installed and serviced by Nanosonics.

Table 2: Revenue by region

A$m	2009	2010	2011	2012	2013	2014	2015	2016	2017
North America	–	–	–	10.2	13.2	17.7	17.7	39.0	62.3
ANZ	0.2	0.7	1.6	1.7	1.5	2.3	2.3	2.5	3.5
Europe & Other	0.1	–	0.6	0.4	0.2	1.5	2.3	1.2	1.7
Total	**0.3**	**0.7**	**2.2**	**12.3**	**14.9**	**21.5**	**22.2**	**42.8**	**67.5**

Source: Nanosonics Corporation financials, SFML research

Table 3: Financial timeline 2009-2017

A$m	2009	2010	2011	2012	2013	2014	2015	2016	2017
Operating Revenue	**0.3**	**0.8**	**2.2**	**12.3**	**14.9**	**21.5**	**22.2**	**42.8**	**67.5**
Cost of sales	(0.1)	(0.3)	(1.0)	(4.8)	(6.4)	(7.6)	(6.9)	(10.6)	(17.4)
Gross profit	0.2	0.5	1.3	7.5	8.5	13.9	15.3	32.2	50.2
Total Expenses	**(9.9)**	**(8.8)**	**(13.2)**	**(12.6)**	**(15.3)**	**(19.1)**	**(22.4)**	**(31.3)**	**(36.8)**
R&D	(3.4)	(2.4)	(3.6)	(3.1)	(3.2)	(4.1)	(4.9)	(7.3)	(9.5)
EBIT	**(9.9)**	**(8.9)**	**(12.9)**	**(5.9)**	**(6.4)**	**(2.8)**	**(5.8)**	**(0.4)**	**12.9**

Source: Nanosonics Corporation financials, SFML research

Table 4: Key company metrics

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Cash balance (A$m)	13.9	21.1	12.4	29.3	24.1	21.2	45.7	48.8	63.0
Installed units							5,000	8,700	12,400
Share price 30 June	**$0.40**	**$0.53**	**$0.77**	**$0.51**	**$0.60**	**$0.79**	**$1.70**	**$2.19**	**$2.54**

Source: Nanosonics Corporation financials, SFML research

Financial comments

Since listing, management have followed a consistent strategy. Funds raised post listing have totalled $64m, allowing for continued expansion in the key global markets of the U.S. and Europe. Following U.S. FDA approval in 2011, sales in North America have accelerated, totalling $62m for the full year 2017. The GE Healthcare relationship has been a large driver of the success in the U.S., a responsibility which will revert to Nanosonics in July 2019.

Following recent positive changes to healthcare guidelines, European sales are expected to climb, with the key markets of the U.K., France and Germany positioned for growth.

Gross margins have expanded and now sit at 74%, a situation that is likely to improve in 2019. Following changes to the GE Healthcare relationship, this will see all consumable revenues associated with the U.S. installed base revert to Nanosonics.

The company fully expenses research and development spend, with Kavanagh guiding to an increased spend in 2018 as new product developments accelerate.

The company ended 2017 with a first-time operating profit of $12.9m and a net cash balance of $63m. While this year will see the company deliver lower profits due to increased research and development spend, beyond 2018 top-line growth will drive increasing net profits.

Research and development

The company is looking to ramp up its research and development (R&D) spend, from the $9.5m invested during 2017 to $14.5m for the current year. This will see the company deliver new products to the market beyond 2019. Kavanagh has already confirmed that a minimum of two new products will be launched from 2018, in addition to a new generation Trophon EPR unit. In April 2018 the company confirmed receipt of clearance for its second generation Trophon platform device (Trophon2) from the FDA. The current level of R&D spend is equivalent to 16% of group revenues and an important driver for future company success.

Management

Since listing, the company has had four chief executives. On the surface this would appear a high number, however, on closer examination, the situation is somewhat better. The exit of the group's original CEO so early after listing saw the appointment of David Radford, who led the company through its FDA approval process. Since 2011, the role of the CEO was handled by long-term employee and director Dr Ron Weinberger. The appointment of Michael Kavanagh, initially as a director in 2012 and later as CEO in 2013 resulted in Dr Weinberger taking on the role of President of Technology Development/Commercialisation. As a co-inventor of several Nanosonic technology patents, Dr Weinberger is responsible for the identification and direction of new products.

Kavanagh's background is equally important. He has over 25 years of international commercial healthcare experience, his last role being at global bionic implant manufacturer Cochlear. Before joining Nanosonics, he was Senior Vice President of Global Marketing, a position he held for more than ten years. Coincidently, the company's headquarters in Lane Cove, Sydney is Cochlear's former manufacturing hub.

Board

The board is led by non-executive chairman Maurie Stang. He has held the role since the company's listing in 2007 and has been involved in the business since its formation in 2000. He remains the largest individual shareholder with 20.2m shares, 6.8% of the issued capital. Although not a board member, Bernard Stang, brother of Maurie, holds 17.8m shares, or 5.9% of issued capital. Along with Kavanagh, the board comprises of six members, with two recent appointments made in 2016.

As at balance date 2017, the remaining board members collectively held 1.7m shares. Kavanagh owns the bulk with 1m shares along with the potential to own an additional 1.2m through performance rights and options.

Summary

Since listing, Nanosonics has done an excellent job in positioning itself for eventual healthcare regulatory reform, by utilising the company’s wholly-owned intellectual property as an innovator in infection protection. The appointment of Kavanagh has provided the business with a clear focus on converting the market opportunity available to them. ***SFM***

Domino's Pizza site visits

Table 5: Domino's Pizza Japan Historical Timeline 1985-2018

Date	Events
1985	First Domino's Pizza Japan (DPJ) store opens in Ebisu, Tokyo, including the first pizza delivery business in the country.
1988	Osaka office is established, opening up opportunities in the Kansai region.
1993	The 100th DPJ store opens in Japan.
1997	First store opens in Kyushu region.
1998	First store opens in Tohoku region, all up 200 stores operating in Japan.
2000	Head office moved from Kamlya-cho to Iwamoto-cho, Tokyo.
2004	Franchising business begins
2010	Bain Capital acquires DPJ
2013	DPJ reaches 250 stores in operation.
2013	DMP acquires 75% of DPJ, with 276 stores and 17% (47) franchisees. 100 Full-time equivalent head office and support staff, along with 4,000 store managers, supervisors and other employees. DPJ being the third largest Pizza chain in Japan at the time.
2014-18	Since acquisition store numbers have expanded: • 2014 - 320 stores (corporate 256, franchise 64 - 20%) • 2015 - 384 stores (corporate 285, franchise 99 - 26%) • 2016 - 453 stores (corporate 320, franchise 133 - 29%) • 2017 - 493 stores (corporate 310, franchise 180 - 37%) • 2018(HY) - 503 stores (corporate 306, franchise 197 - 39%) Long term store potential 850

Source: Company announcements

Table 6: Domino's Pizza Japan Financials

Year ending 30 June	2014	2015	2016	2017	2018(H)
Network Sales A$m	260.0	349.0	450.0	487.0	243.0
Revenue (A$ m')	241.0	314.0	401.0	418.0	205.0
EBITDA (A$ m')	27.0	38.0	48.0	56.0	24.0
EBIT (A$ m')	22.0	29.0	33.0	38.0	19.0
Sales per store (A$ m')	0.900	1.050	1.010	0.980	0.480
EBITDA per store (A$ m')	0.100	0.110	0.110	0.110	
Sales per store (JPY m')	75.0	87.0	84.0	81.0	42.0
EBITDA per store (JPY m')	7.90	9.50	8.90	9.30	
Same-store-sales	10.70%	1.80%	-2.10%	-0.60%	-1.90%

Source: DMP Corporation financials, SFML research

Table 7: Since acquisition Domino's Pizza Japan store growth

Year ending 30 June	2014	2015	2016	2017	2018(H)
Corporates	256	285	320	310	306
Franchisee	64	99	133	180	197
Stores	320	384	453	493	503
% Franchisees	20%	26%	29%	37%	39%

Source: DMP Corporation financials, SFML research

During the quarter we embarked on an ambitious program of company visits that included management meetings with Domino's in Japan, Germany, the Netherlands, and France. On returning to Australia, we met with the Chairman Jack Cowin in Sydney, and the Group CEO Don Meij, in Brisbane.

Our goal was to gain insight into the opportunities and challenges faced by Domino's Pizza Enterprises (DPE) which trades under the ASX code DMP.

Our motivation was two-fold. Firstly, the business has come under pressure on multiple fronts. We have identified three broad buckets of issues. Each of these buckets has played a role in halving the share price from top to bottom, during an 18-month window from 31 August 2016 to 31 March 2018. They include:

1. Operational issues (flowing to earnings and guidance),
2. Regulatory issues (including franchisee relations),
3. Public scrutiny (including broad media coverage and a peak short position of 18.31% on 17 May 2018).

Secondly, we wanted to gain better insights into some of the business drivers that are important to us:

1. Culture (by meeting with the individual country managers in their respective countries),
2. Governance (by meeting with both management and board representatives),
3. Scale (the longer-term opportunity within each country).

We also wanted to tour the new and old commissary operations in France and the Netherlands respectively. This was an area of the business we were not familiar with. And finally, as simple as it might seem, we wanted to gauge first-hand the quality of the product in each of the regions. We are firm believers that if the product (in any business) is poor, the sustainability of that business is going to be challenged.

Much ground was covered over many days of meetings with management and staff, too much, in fact, to cover in this article. In this piece, we will focus on Japan.

Photo 1: Domino's Pizza Japan street-side promotions

Source: SFML Japan trip

In early May we travelled to Japan to meet the new executive team responsible for Domino’s Japanese operations. In the two days available, we held management meetings and toured a variety of Domino’s store formats and competing offerings from Pizza Hut, Pizza-La, 7-Eleven, Lawsons and Family Mart whom all offer dining alternatives in a country known globally for its great food.

Management

The new country President of Japan is Josh Kilimnik. He has been in the role since January 2018 and is the first DPE appointment, following nearly eight years under the management of U.S. private equity firm Bain Capital. It’s a subtle but important shift. The country head is now an experienced pizza store operator rather than a financier.

While it might be an exaggeration to say Kilimnik has *“pizza sauce running through his veins”* he does have deep experience across the Domino’s business. We make a point here because this level of experience is not uncommon, in fact, its refreshingly typical across the senior management team and country heads of DPE, bar one. This is an important distinction that is often missed in governance discussions. It’s an issue we will revisit later.

Kilimnik started *"rolling pizza dough"* at the age of 14, at Jacko's Dial-a-Pizza in Canberra. Over the next five years, he worked in every role in the store. Jacko's was acquired first by Silvio's and then later by Domino's. Kilimnik stuck around and went on to run the Belconnen Domino's store in the ACT.

Around that time, he tossed up buying a store but instead went to University in Queensland. After graduating, and following stints at David Jones and Pepsi he was brought back into the fold at Domino's. During his second stint at DPE, his roles included working as a Franchise Consultant, having responsibility for procurement, and National Quality and Audit Manager.

In 2003 Kilimnik landed in Melbourne. He soon learned that starting three stores from scratch, in a new territory, was tough going. However, within 18 months, they obviously gained traction, as the Melbourne region grew to 52 stores.

Kilimnik moved in 2011, to head up the local Domino's New Zealand operations, when same-store-sales (SSS) were in decline and customers were leaving. In New Zealand Kilimnik gained a reputation for turn arounds. He put his success down to a great team who were comfortable in setting and working hard towards a single goal.

Kilimnik gained significant global experience when he left DPE in 2013 to join Domino's Pizza Inc. (DPZ), with the blessing of then Chief Operating Officer Andrew Rennie. The move to DPZ is not a typical path for DPE executives.

At DPZ he was responsible for the Middle East and Europe. This included experience across some smaller start-ups in Africa and exposure to the larger businesses of Turkey, Russia and South Africa.

Kilimnik's time in the Domino's system is indicative of the experience of senior management and country heads across DPE, including CEO Don Meij, CEO of Europe Andrew Rennie, CEO of Australia and New Zealand Nick Knight and CEO of France Stoffel Thijs. All started life working in Domino's stores or other branded pizza operations eventually acquired by DPE. The outlier is Andre Ten Wolde CEO of the Netherlands, who has a corporate background, and somewhat of a chip on his shoulder because he can't make pizza.

Don Meij has 40 years' experience in the Domino's system. This is unusual in a public company where CEO turn-over is high. He is effectively the founder. His equity grants reflect his long tenure and the success he has had in driving earnings growth over the long term. Collectively this management team represent decades of instore experience as hands on operators rather than as head office financiers. They understand what it takes to make an individual store successful, and what motivates franchisees. Over many years they have developed close working relationships with many franchise operators who run successful businesses within the system.

Management also know that 10% of franchise operators will not make the grade, will take short cuts, mismanage staff and the business and even game the system in the short term. An "A", "B" and "F" rating system is deployed, with the bottom 10% of performers falling into the "F" category. This category is undoubtedly a painful experience for franchise operators.

With a failing business comes financial stress and personal pressure. This is not restricted to franchised business models. Globally 50% of small businesses fail and close.

It was interesting to observe that the *"hardest head"* is Andre Ten Wolde, CEO of the Netherlands, arguably one of DPE's most successful countries. Wolde describes himself as firm but fair; he has 13 years of experience at Domino's, exclusively in management. Andre was employed by DPZ to turn the small Netherlands operation around after it had floundered under U.S. stewardship, before being on sold to DPE. Wolde believes that those that fall in the "F" category should be exited from the system quickly. In a business sense, he is correct, yet the approach of this deeply experienced DPE management team is to work with franchisees to progress them from the "F" category to the higher rating before forcing the exit only after they can't make it. Outside these ratings, all agree; misbehaviour, once uncovered is not tolerated.

Photo 2: Domino's Pizza Japan, Sumida Kikukawa store

Source: SFML Japan trip

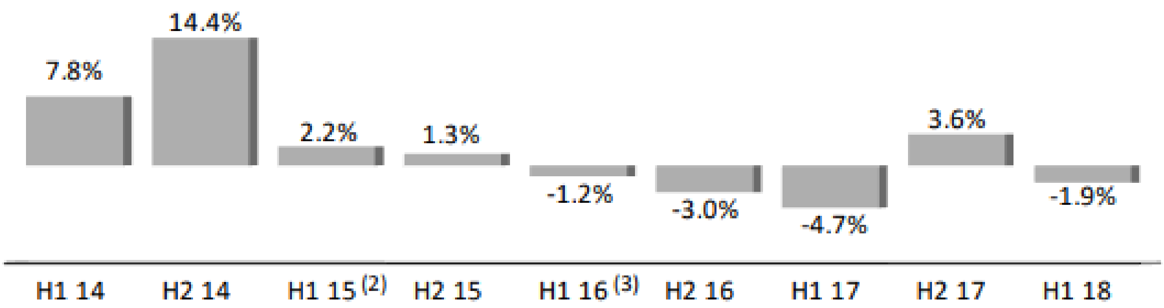
Other store failures are location driven. We visited one of the most successful franchisees in the Netherlands. His first store was spotless, had soft lighting and music. It was an inviting atmosphere. He described how he loved to go to work at this store and he was building a third store that would include an open fire place as a key differentiating fit out drawcard. He planned to try marketing hot chocolate to customers. The new supersized fit out was built at his own expense. His second store was a financial non-performer, a dud, that was losing money and clearly a cause of stress. The product wasn't resonating with the local community even though these two stores were less than 10 kilometres apart. Not all stores work.

Today, technology is being deployed to increase both oversight and decision making based on data rather than gut feel or reactionary measures. Data driven learnings are increasingly being used to new drive store locations and splits.

The DPE corporate entity receives royalties of 7% of sales. Additional levies of 4%-6% are made to fund group marketing budgets and are voted on and approved by franchisees. This is a business arrangement that drives an average store EBITDA of $135,000 (FY17). The earning outcomes for "A" category franchisees will be higher and "F" will be lower and or even loss making. That's business.

As the master franchise, DPE is not predatory, it operates a high volume, high-performance culture driven by a management team that has deep operational experience. No doubt improvements to the system can be made. We believe DPE are making investments ahead of the curve to improve the system. DPZ is doing the same and DPE leverage off that investment also. The global Domino's network benefits from the collective learnings and experience of operating in 88 regions around the world. Kilimnik is uniquely placed to draw ideas from across the globe.

Photo 3: Domino's Pizza Japan same-store-sales growth



Source: DPE ASX disclosures

Japan

Fast forward to 2018, and after being employed by DPE for the third time in his career, Kilimnik was appointed as country head responsible for Domino's Japan (DPJ). From the outset this was not the easiest posting, SSS for the proceeding periods had been flat or in decline and DPE FY18 guidance for the 503 Japanese stores sits at an uninspiring 0-2%. In assessing this outlook, two factors were clear.

Firstly, DPJ was in need of management change. Private equity has a useful life. We say this because they enter an investment wanting an exit, often measured in years. Rightful owners of a business do not have this mentality. They understand that investment ahead of the curve is an ongoing requirement of business, rather than a lever that can be pulled to increase financial optics. After eight years Bain didn't want to invest. Instead, they wanted an exit, and DPJ became insular in this period.

An occasion

Secondly, the Japanese market has its quirks, some which we understood and others which were learnt during our travels. It's well known that Pizza is considered an *"occasion food"* reserved for special events. KFC also falls into this category. By way of example, KFC own the December 25 festive occasion. They have substituted fried chicken for turkey, giving a *"western experience"* at Christmas. It is McDonald's who have *"cracked the code"* with burgers according to Kilimnik. They are the first to move away from the event culture successfully, recent double digit SSS growth would support this theory. We discuss the learnings from McDonald's below.

Kilimnik believes he has the right team in place to move forward and importantly execute. Chief Financial Officer Eric Yutaka Tai has been in the role for 18 months and Chief Technology Officer Saeed Khan for eight months. The management team will be supplemented by a Chief Marketing Officer who will be seconded from within DPE's Australian executive ranks. This stands out as a key appointment.

In terms of existing operations, Kilimnik sees low hanging fruit in procurement, store layouts, and operational efficiency. In fact, he is spending approximately 60% of his time on operational issues. As we travelled around different store formats, Kilimnik pointed out common sense operational changes that were being examined. He is not focused on margin, rather he sees this as an outcome of operational excellence.

These included dead floor space, bench widths, distance from *"make space to oven"*, old fashioned punch clocks remain in use while digital systems sit idle because training is required. Pizza box shapes are under review, the current model looks like a magical work of origami. It contains folds angles and even plastic supports. The quattro pizza that DPJ invented and is now the industry standard contains a piece of rolled *"dough stick"* added to the pizza base as a visual separation for the maker to work off. Its application is time-consuming, expensive at 15 cents a pop and redundant.

Kilimnik, backed by his operational team, can see where change is needed. He points out that change management needs to be based on a review of data rather than gut feel. Domino's technology rollout of OneDigital, introduced in January 2018, was not without its issues, as it was dialled back to enable the continued use of the voucher system. Kilimnik sees it as a critical time for Japan, and acknowledges that it takes time to learn to operate, he will not chase SSS as a *"knee jerk reaction"*.

Longer term operating targets also abound. Interesting examples include examining opportunities for back of store dough production and the scale required for national advertising campaigns in a country that consists of 57 separate television markets.

How do you make dough?

Dough is a big deal. In Australia DPE make fresh dough balls in each store from scratch. It requires flour, water, yeast, a mixer, bench space and cold room storage. In Europe DPE inherited and now operate centralised dough production. In France, one of two facilities is state of the art. In the Netherlands, a single commissary manufactures dough using a labour-intensive process linked by some moving belts. It's a bottleneck, but it's in the process of being replaced. Under this centralised production, dough balls are sent out across the country to stores daily.

Japan is different again; a third party is employed to manufacture and distribute dough balls from six sites. This is expensive and a handbrake on operations. DPJ operates 503 stores across Japan but none on the North Island of Hokkaido (population 5.5 million), because the third-party operator does not have facilities there.

Inefficiencies have also become institutionalised, as the third-party providers are bakers and this is not their core business, nor were Bain Capital pizza operators. Transporting air and water for one hour from outside Tokyo is expensive.

Photo 4: Third party made dough

Source: SFML Japan trip

After spending time in stores, it didn't take Kilimnik long to realise each delivered tray had space enough for 15 dough balls rather than 12. That's three extra per tray, easy maths that Bain Capital missed.

In fairness 15 years ago, in-house dough making was an issue. Today, the technology and efficiency on a store by store basis is excellent, making this a lower risk option. In time the EBITDA margin benefits could be as high as 3%. At the half year, EBITDA margins in Japan where 11.5% v 21.6% for the group.

Customers

Kilimnik sees two separate customers in Japan, delivery and take out. They represent separate markets and need to be treated as such. This ties into the bigger question of scale. The North Island is a prize worth chasing, as is national TV marketing. It comes down to *"cracking the pizza code"* in Japan, as McDonald's have done with burgers. Domino's need to shift pizza from an *"occasion food"* to a more regular offering.

DPJ also aim to offer a compelling *"third space"*. This has been done well by Tully's and Starbucks. As an aside breakfast is hard to find in Tokyo before 8 am – so we tried both venues. The *"third space"* is specific to Japan. According to the Japanese government, the minimum living space recommended for a healthy lifestyle is 25 square metres per person. This would be deemed small by Australian standards where the average house is 233 square metres. A quick search of the internet indicates that only 30% of households in Tokyo's 23 wards achieve the minimum, with the average household having 19.1 square metres per person. The third space offers a comfortable external alternative to the home or office, to dine and spend personal time on a computer or connected device. Internet connectivity, quiet music and an unhurried environment make for an attractive third space option.

Finding real estate in Tokyo remains difficult. The ideal footprint is 140-180 square metres and opportunities exist to take space from Lawson's and Family Mart as they seek to move to bigger sites.

DPJ is four months into the sit down eating concept. We visited several Mugden-4.0 store formats that measured up well against Tully's offering. We also visited examples of pre-Mugden formats. There are some 70-80 of these hole-in-the-wall or garage type outlets that look like Pizza La outlets. They are average and uninviting and need to change.

Delivery is a big opportunity in Japan and DPJ aims to own this space through a combination of technology, offer, service and execution. The introduction of technology is in its early stages, and as alluded to, it is not without risk. While this is unlikely to be an easy task, DPJ's options have increased under new management who are less insular and are looking to leverage the best and most successful initiatives available from any of the 88 markets in the Domino's global network.

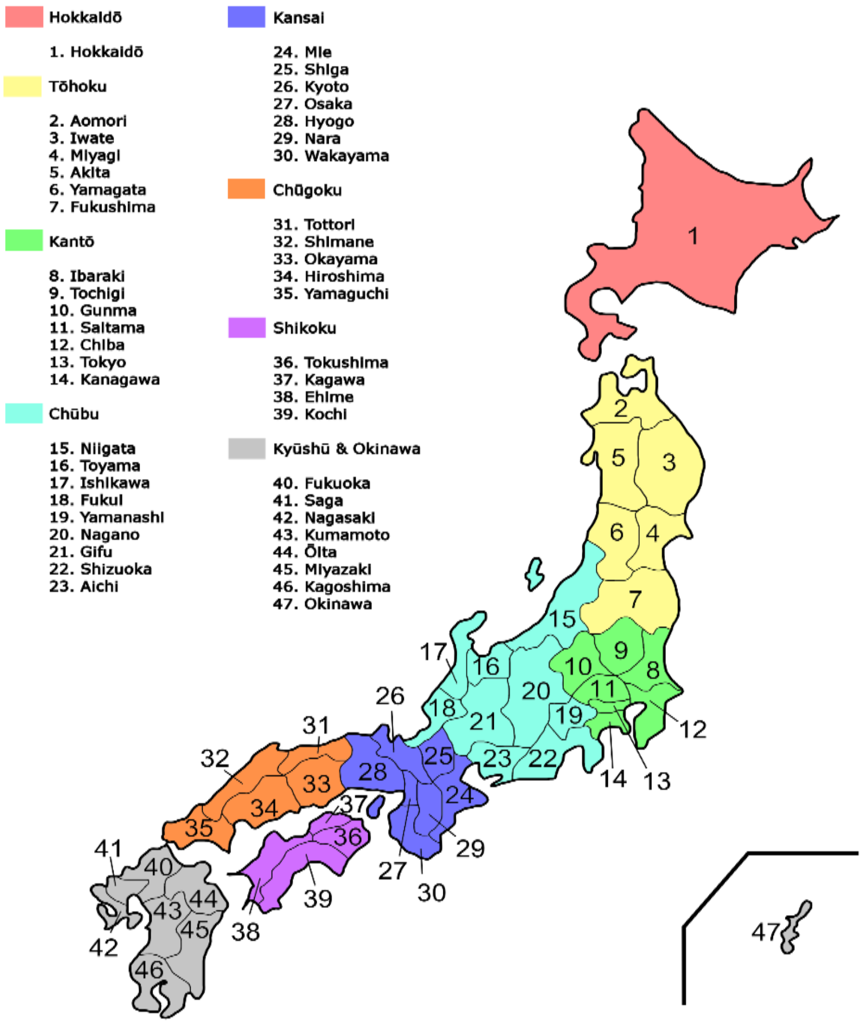
Pricing

Tokyo itself is famous for pop culture. Kilimnik notes that Japanese consumers love anything new that may be perceived as the 'latest and greatest' offer. To date, DPJ has had some success in marketing through innovation. The quattro pizza, for example, which Domino's introduced to Japan is now an industry standard. Discounting is a different story.

Discounting is used extensively across the global Domino's network as a means of driving sales volume. Two-for-one offers and free sides are common forms of promotional discounting. In Australia, the $5 pizza has been a hard-fought battle ground that was won by DPE.

Kilimnik was quick to point out that discounting is successful in every country that Domino's operates in. However it does not work in Japan. The Japanese perception of quality and value can be eroded by discounting. Other methods such as two-for-one and tiered pricing may be more successful in this market.

Figure 13: Japanese regions and prefectures



Japan is a country divided into eight regions consisting of 47 prefectures. Tokyo itself is spread across three regions accounting for 36 million residents. The Tokyo metropolis alone has a population of 13 million. In total Japan has a population of 127 million.

Japan has quirks not found elsewhere. Pop Culture and discounting are but two examples. To date, Pizza Hut and Pizza-La have pursued a one size fits all global strategy, which will not succeed in lifting the Pizza category out of the *"occasion food"* bracket.

McDonald's has had success in running a three-tiered pricing strategy across the country. This is a strategy that will be tested by Domino's. Data will be used to determine pricing thresholds across the various regions. With a wealthier, time poor population of 36 million people who have a lengthy daily commute, the three prefectures that make up Tokyo are large enough to be treated as a separate country with its own unique tiered pricing strategy. Combined with a successful two-for-one strategy it may be possible to shift pizza consumption over time.

The ¥500 pizza (A$6) will also be tested along with additional plays from around the world. Execution of these strategies, according to DPJ, will be data driven not gut feel or reactionary.

Cash

Japan maintains its deep links to a more traditional society. They are wide ranging and include global oddities such as the dominance of the postal savings system which has stifled investment and the continued use of cash over credit. As we travelled around Tokyo, it became apparent that business and retailers of all shapes and size preferred cash while credit cards are either less welcome or just not accepted. There is a good reason for this. Japanese banks provide many types of credit offerings to customers and this adds complexity to a system that is not standardised at the point of sale.

Perhaps even more telling is the disconnect, for a business operator, between accepting a credit card payment and the point of cashflow in his or her bank account. It can take up to two months after the purchase for a business to be paid by the credit provider or bank. This cashflow distortion is not well understood by the market.

At present 30% of DPJ transactions are driven by credit card payments. That may seem to be at the lower end of expectations in a digital world that is moving away from cash. By way of contrast, our credit card was not accepted at a modern Tokyo Pizza Hut operation that we visited. Pizza Hut Japan is a cash only business! The cash economy that prevails in Japan is a stark contrast to other Asian markets. Obviously, China is leading the way with digital payment options which are attached to digital platforms provided by Alibaba, Alipay and the WeChat offer from Tencent.

Culture

There are some subtleties between the rigid nature of Japanese culture and the need for change within the business itself. Kilimnik notes it’s important to change the culture at DPJ rather than attempting to change Japanese culture which would be an arrogant approach, destined for failure. The *"Kaizen concept"* is a Japanese approach to continuous improvement. The DPJ management team are taking this approach to the development of stretch targets that can drive the Domino’s high-volume sales mentality required for scale.

Existing Japanese culture is not devoid of some significant benefits. This can be found in the sticky casual workforce which has very low attrition rates compared to other regions. Long tenure of employment was a common thread throughout Japan. Store managers have been in place for 22 years in some instances. DPJ has 40% driver turnover, where this can run as high as eight times per annum in other markets.

The DPE developed Tanda system will be employed in Japan to manage rosters staffing and payroll. The predominance of corporate store ownership means that Japan has not faced the pay issues that have dogged other regions.

Corporate

Japan is seen as a more capital-intensive business. At present, 60% or 306 stores are under corporate ownership out of the total 503 store footprint. Capital will be released as stores are sold off through the *"Can Do! Partners"* franchising program.

Initially, DPJ finances the franchisee and after two years of profitability, bank financing can be achieved supported by a government guarantee system. The current DPJ franchisee tenure average is four years verse 10 years plus in Australia. These are early days, for Kilimnik, in the push to grow a group of individuals that can support the rollout of a national footprint of 850 stores. The pipeline of potential franchisees is currently not good enough and this is a key focus.

While early days, Kilimnik is bullish, but he is also determined not to push faster than is sensible. *"Great franchisees challenge the system which drives business learnings. We have been selling more stores and building more and do not see difficulty in achieving 850 stores."* There is no guarantee, however, that this occurs in a timeframe demanded by financial markets. Real scale in Japan requires 1,000 stores and as we have noted there are no stores on the North Island at present.

As with other regions, Japan will not move completely away from corporate store ownership. There is significant value in corporate ownership. It is an enabler of change in a franchise system. The franchise needs to be consistent with the brand and while internal improvements are required, it is easier to drive these improvements at the corporate level and then out to franchisees.

Technology

Domino's is known for its rapid rollout of technology. While it will play a key future role, in Japan, the rollout is in its very early stages and has yet to have any real impact. This reflects Bain Capital's willingness, or lack thereof, to invest in the country.

OneDigital was rolled out in January 2018 but had to be wound back shortly thereafter due to incompatibility with voucher production. DPJ now have a backup system in place for next three months to be able to run the voucher system. As with all things, Kilimnik notes it takes time to learn to operate in a new market. Other examples include the SMS technology platform, which DPE is an active user of in Australia. In Japan, SMS costs eight cents. In Australian, an equivalent SMS costs one cent and is an acceptable way to contact and communicate with customers. In Japan an unsolicited SMS is considered a bit rude, **an email is more acceptable**. These limitations will be overcome. Again, the common theme here is time which many investors don't seem to have.

Kilimnik views it as a critical time for Japan. *"We don't want to manage same-store-sales growth by knee-jerk reactions. We don't want to damage the business."* Maybe DPE could learn from this. Long term growth is more important than rocket fuelled guidance that puts stress on systems and people.

In summary, after two days of meetings it was clear that opportunities abound, low hanging fruit is evident, but a steady hand is required. We are confident long-term growth will be achieved.

According to Kilimnik, Japan feels like a pioneering market. He draws on his experience of Nigeria, which was a single pizza brand market which was tough. Pizza, like burgers, already fit into Japanese culture. No doubt, the first challenge is to change the trajectory of consumption. Tiered pricing, two-for-one offers, loyalty programmes and alike may combine as the catalyst.

The pipeline of people coming through the business will be the second key driver of success. As noted this is not good enough currently. Some things just take a lot of time. DPJ need to build this structure out as they arguably need to do in the U.S. Team leaders need to be coached and developed. Training needs to be added to create a solid road to becoming a franchisee. A business Intelligence piece needs to be developed including, balance sheet and profit and loss training modules. Single and multi-unit franchisees need to be developed without stalling the corporate store manager base. The expectation is that 3-5 years of investing in staff is required. Establishing a pipeline of mangers who can become franchise operators is the key to long term businesses success and achieving scale of 1,000 stores in Japan.

Store visits: DPJ versus Pizza Hut taste tests

DPJ experience:

- We tested hot out of the oven food which is always superior to the delivered equivalent.
- No doubt meticulously prepared for us.
- Quattro pizza quality and taste was excellent.
- Wedges were poor.
- Chicken nuggets just OK.
- Desserts excellent with a unique homemade look.
- Salad was good.
- In store dining experience was excellent.

Photo 5:Domino's Pizza Japan offering

Source: SFML Japan trip

Pizza Hut Food experience:

- Cash only transactions. Would not accept credit cards.
- This pizza was lesser quality even though fresh from oven.
- Kilimnik thought the dough weight was light, but we didn't expect favourable commentary.
- Tomato sauce flavour was strong and dominated toppings.
- Chicken was larger but had more *"Steggles"* industrial crumbed flavour.
- In-store dining experience was average, but we had been taken to this store by DPJ.

Photo 6: Pizza Hut Japan offering

Source: SFML Japan trip

SFM

Capital mis-allocation

Conglomerate Wesfarmers, a $52b top twenty Australian listed company has a lot of explaining to do, having just dusted a reported $1.7b on its U.K. hardware adventure.

This is not the first time management at Wesfarmers have ventured down questionable paths. A desire to repeat their Bunnings hardware success in Australia, saw the group move into the U.K. with the purchase of Homebase in 2016. Ironically, the decision to move on Homebase was made the same day that hardware rival Woolworths announced it was shuttering its Masters operations in Australia.

It's hard to know the exact reasons why new CEO Rob Scott has pulled the plug less than two years in but operating losses were piling up and an admission that their hardware offering was not up to scratch is a disturbing and frank assessment.

Scott is now telling shareholders that a change in strategy is required and remuneration will be impacted as a result.

“Clearly there have been negative financial implications from this, and from a management point of view we are all shareholders and will feel the pain of that and there will be remuneration implications from the impairments and from the losses and we will ultimately disclose that to the market in due course. From a management and board point of view we fully understand the buck stops with us, and there needs to be that accountability.

All I can say at the moment is that I fully expect, and it is not ultimately my call, we go through a remuneration committee and board processes and so forth, but it is my expectation there will be significant remuneration implications as a result of the impairments.”

It's rather unfortunate that the CEO in charge at the time, Richard Goyder, and the CFO are long gone. Everybody wants managers to be accountable, but when they’re no longer around to answer for their decisions it’s difficult to achieve.

Scott now openly reassures shareholders that management will pay. Sounds admirable but the devil is in the detail and shareholders will have to wait.

So, in a world of investor activism, what is an appropriate response? We are often asked to vote on all matter of issues on behalf of our investors. In the case of Wesfarmers, we have no shareholding and there is little evidence to suggest our thinking will change on this matter.

But what of current shareholders, most notably the large pension and investment funds? While remuneration matters are always a hot topic and opinions differ materially, Wesfarmers and its board and management team need to be singled out.

Let's see whether the voting bodies that direct how votes should be cast force some action. We wouldn't hold our breath having witnessed how voting groups have misused their power in the past, but we live in hope.

In the meantime, Wesfarmers CEO Scott is encouraging the team to move on, *"While it is important that we learn from this experience, this should not discourage our team from being bold and diligent in pursuing opportunities to create shareholder value."*

We don't agree, and the jury will remain out until some genuine *"show me the money"* accountability is evident.

Wesfarmers - Investor day

Continuing with the theme, at the group's investor day held in June, business conglomerate Wesfarmers outlined the path forward. Following a disastrous foray into the U.K. hardware market, costing the group $1.7b, the new CEO emphasised a slower, more patient, organic approach, one where a five to ten-year investment view needs to be considered.

Unfortunately, taking a long view doesn't fit well with many in the market, highlighted by an analyst's question suggesting that investors don't have the luxury of thinking like that, and instead, a two to three-year time horizon was more appropriate, *"What are you going to do to get you out of that rut, that makes Wesfarmers exciting to invest in over the next two to three years?"*

But that type of comment from someone with little knowledge or actual business acumen is precisely why CEO's end up doing silly deals, to drive excitement and keep analysts employed. The problem appears to sit with the analyst and those in the market who think in the same way rather than with Wesfarmers, but as we have already witnessed, the pressure applied is such that it does end up influencing management behaviour.

So, what's the answer? Thankfully, we agree with Scott's parting comment, *"It might sound a bit boring, but running a portfolio of exceptional businesses really well."* Over to you Mr Analyst. ***SFM***

Trade wars

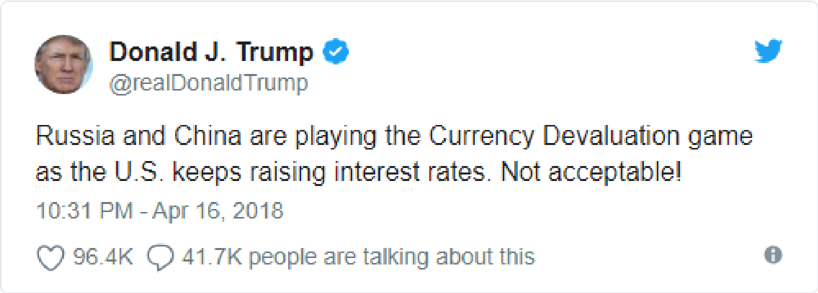
On 22 March 2018 Donald Trump signed a memorandum to impose tariffs of US$50b on Chinese goods. The U.S. President expressed his desire to close the US$375b trade deficit, which he blamed on a number of Chinese trade and foreign investment policies as well as currency manipulation.

The trade deficit is an outcome of the United States importing more goods and services to China than it exports. Consumption is a major driver of most economies. However, imported goods or services drive the economy of the exporting nation rather than the importer. In this case, the U.S. consumes US$500b of goods and services from China while exporting far less, roughly US$130b. On face value, it would be fair to claim that the trade deficit with China is a drag on the U.S. economy.

Understanding the impact of trade flows on an economy is far more complex than comparing bilateral trade deficits and surpluses though. Consider how the trade deficit would change if China purchased an additional six billion barrels of oil from the U.S. at US$70 but then immediately sold it on to other countries. U.S. exports to China would have increased to US$420b and, assuming nothing else changed, U.S. exports to China would now total US$550b, flipping the deficit to a surplus of US$50b. Consumption of oil hasn't increased by 6 billion barrels though. The nations that purchased those barrels from China would probably have simultaneously reduced their purchases from the U.S. While the trade deficit with China will have flipped to a surplus, the U.S. trade deficit with the world should remain unchanged. Reducing a bilateral trade deficit in isolation does not necessarily grow an economy.

If Trump does succeed in having some of the protectionist measures that China has in place removed there will be plenty of positives. Unfortunately, the changes that are likely to benefit global trade will probably not happen on a timeline Trump finds attractive. Perhaps his belligerence when it comes to negotiating could succeed in speeding up some of the deregulation in China.

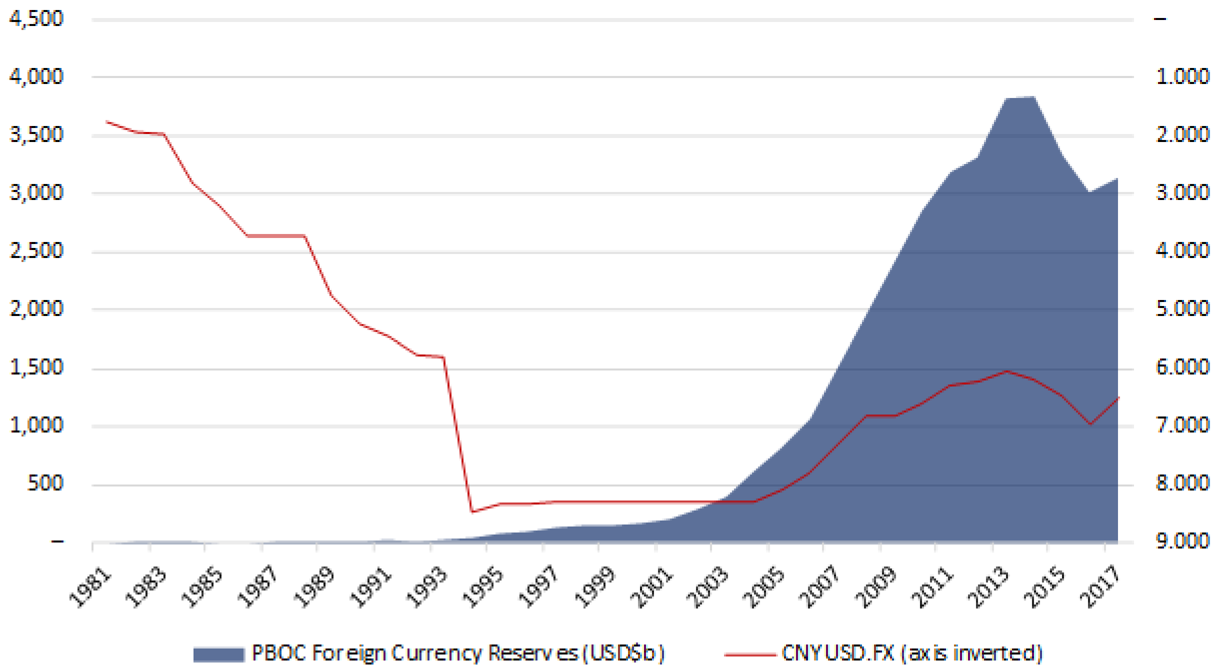
From 1949 through to the 1970s the Chinese government set the exchange rate at an overvalued level to reduce the cost of imported machinery and equipment for their domestic industry. Between the 1970s and 1990s, the government shifted the foreign exchange mechanism from a fixed to a managed floating rate system, whereby the People's Bank of China (PBOC) set a rate based on market supply and demand, however, the currency was deliberately depreciated through this period. The PBOC has been criticised for maintaining a rate well below the level it would settle at naturally, to support domestic exports and reduce the affordability of imports for local consumers and industry. Trump has explicitly taken exception to the current exchange rate settings claiming they amount to currency manipulation.



Maintaining an exchange rate below the level it would set naturally based on supply and demand requires large-scale purchases of foreign currency by the PBOC to hold down the exchange rate.

The steady accumulation of foreign currency reserves as illustrated in *Figure 14* is clear evidence that the PBOC has been a steady seller of the Renminbi since the early 1990's. Two-thirds of these reserves sit in U.S. Dollars. This pattern ceased for a period, however, in 2013 as the PBOC sought to prevent an uncontrolled devaluation as concerns of a capital flight increased**.**

Figure 14: PBOC foreign currency reserves vs Chinese Renminbi/USD exchange rate

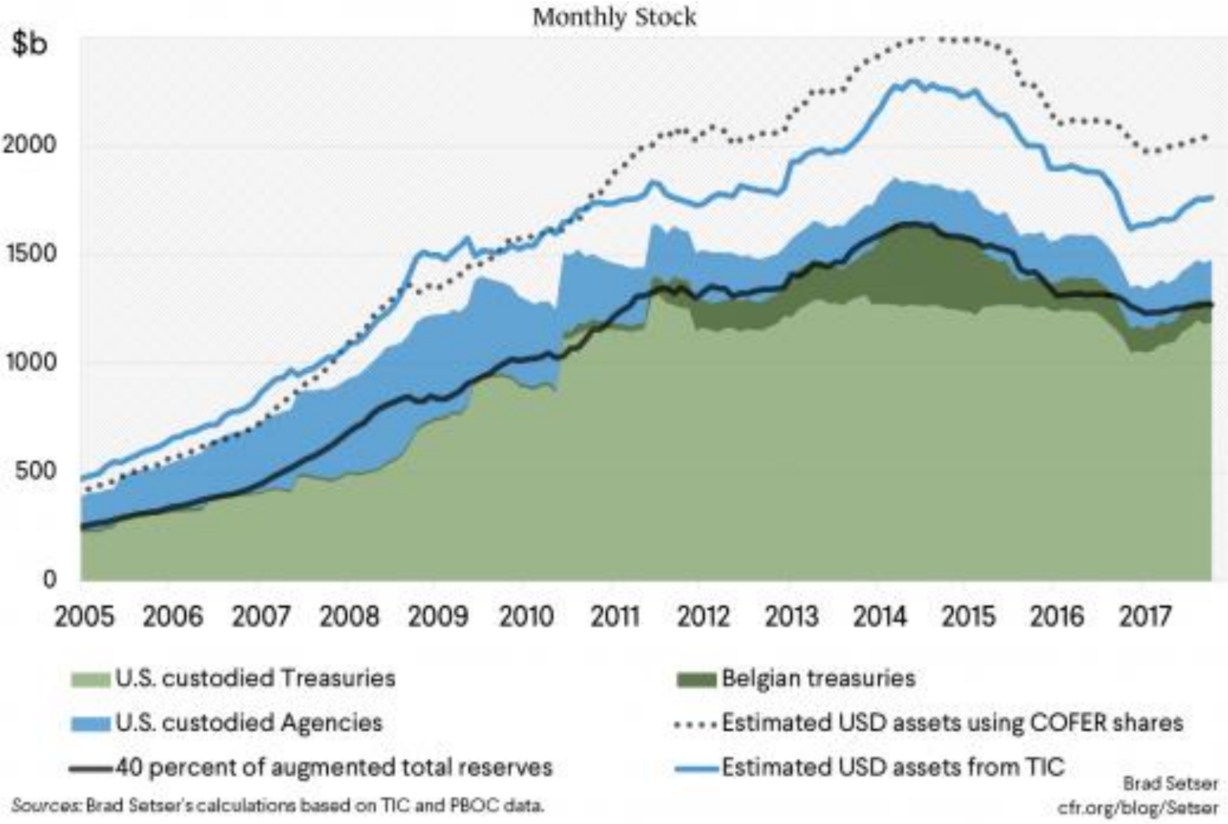


Source: PBOC and Federal Reserve Bank of St Louis data

China's management of the Renminbi exchange rate is to blame, to a certain extent, for lower than expected consumption of internationally produced goods and services in China. Likewise, increased affordability drives consumption of Chinese goods and services, exacerbating the U.S. trade deficit.

The flip side of this argument is that while the U.S. has consistently run a current account deficit, buyers of U.S. Dollar denominated debt have funded that deficit. China has been one of the largest buyers, with PBOC holdings of U.S. Treasuries currently amounting to an estimated US$1.25t as illustrated by the U.S. custodied Treasures component in *Figure 15*.

Figure 15: PBOC holdings of USD assets



The original memorandum detailing the trade sanctions against Chinese manufactured products reveals some insights into what the Trump administration was trying to achieve and more importantly, the trade policies they were taking exception to. Tariffs targeted products in industries where regulations put international businesses at a disadvantage to domestic ones in China. Some of those regulations include loose intellectual property laws and requirements for international companies operating in China to partner with local companies.

A large proportion of the goods the U.S. imports from China are finished goods. The largest categories of imports from China by value include computers, phones, clothing and toys. As finished goods, there are fewer middlemen between the importer and the consumer to absorb increased costs. U.S. consumers will have to wear the majority of these price increases as there are few participants in the supply chain to absorb the cost increases.

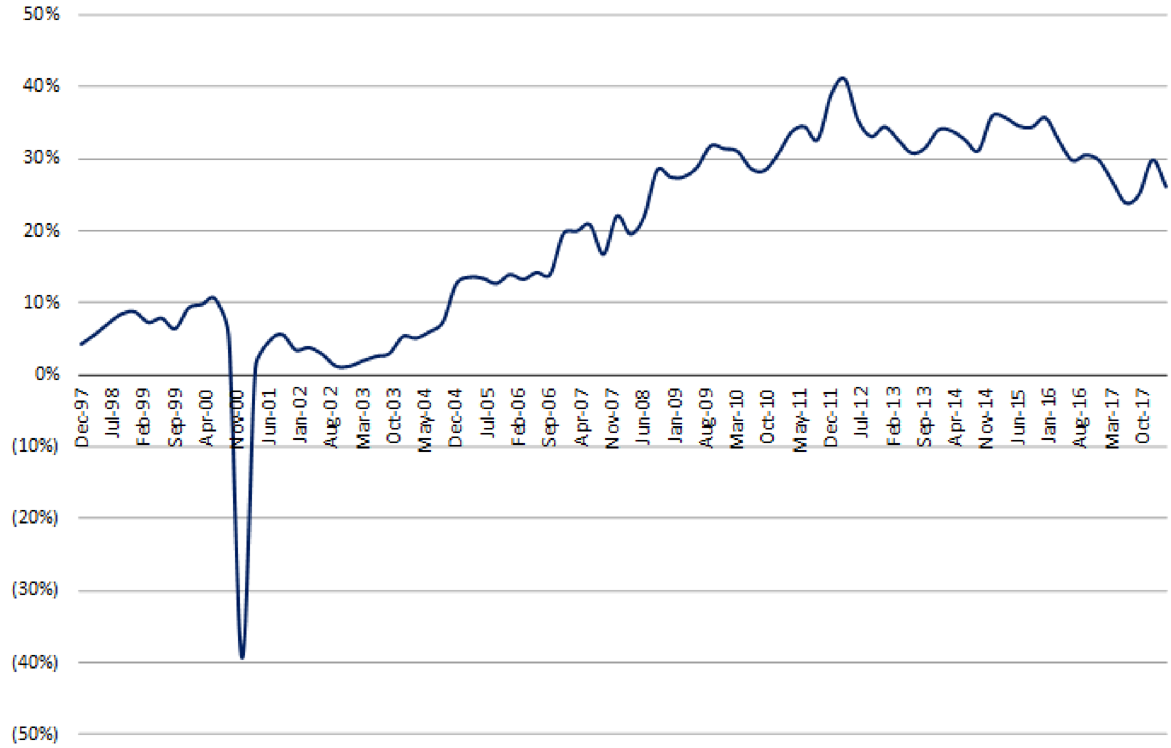
The ideal outcome Trump has in mind is an immediate increase in U.S. manufacturing, replacing imported with domestically produced goods. A tight labour market and higher labour costs probably make that unfeasible for most manufacturers, not to mention the complexity such a change would cause.

What's more, around one-fifth of U.S. imports come from China. In contrast, only 9% of the goods China imports are from the U.S., the majority of which are either unfinished goods or parts. These include semi-conductors (one of the most successful export industries in the U.S.), soybeans, cars and integrated circuits. Retaliatory tariffs from China would see higher costs absorbed by numerous participants in supply chains before they impacted consumers, resulting in more muted prices rises for Chinese consumers. The goods exported from the U.S. to China are also far more substitutable with goods from other countries than the reverse.

Perhaps more important is the degree to which large U.S. corporate supply chains rely on Chinese manufacturing to bring products to market. In the late 1980s and 1990s, western firms such as Apple and Intel made great gains by investing in China to take advantage of cheap labour. Shifts in corporate strategy, particularly in the late 1990s, saw western firms shift towards contract manufacturing models.

When Steve Jobs' eventual successor Tim Cook joined Apple in 1998, he set about revamping the company's supply chain. Apple factories around the world were closed and Cook built relationships with contract manufacturers such as Taiwan based Foxconn. Also known as Hon Hai Precision Industry Company, Foxconn went on to become Apple's primary supplier. Their main manufacturing facility in Shenzhen, China which churns out iPhones and iPads is located on an 850-acre campus and has housed upwards of 400,000 employees at times. This shift saw Apple's gross margins and operating margins rise sharply through the early 2000s. At the same time, even though it operates on much tighter operating margins, Foxconn grew into a dominant force within the contract manufacturing industry, generating around US$150b of revenue in 2017.

Figure 16: Apple operating margins



Source: Apple SEC disclosures

Apple's success is due in large part to their ability to manufacture premium products in low labour cost countries. Apple would not be anywhere close to as profitable as they are now without the help of the labour cost arbitrage they use through the Foxconn relationship. It was reported in 2012 that, working a 160-hour month, Foxconn employees could expect to earn as little as US$400. Workers would regularly earn more than this by working long spells of overtime. In contrast, the minimum wage in the U.S. is currently US$7.25 per hour, which would equate to US$1,160 a month for 160 hours of work.

As specialists in developing countries progressively took over the West's manufacturing, China put in place protections to prevent exploitation of its labour force. An approval system for foreign investment was established, requiring foreign businesses to partner with local firms, transferring knowledge and skills to the local Chinese market. Further, China promotes the growth of intellectual property (IP) domestically by giving preferred supplier status to manufacturers of high tech products whose IP is owned or registered in China.

The *"Made in China 2025"* policy unveiled in October 2015 identified a number of industries that China wants to be globally competitive in by the year 2025, including robotics, new-energy vehicles, aerospace and software. Many of these were directly targeted by tariffs imposed by the Trump administration. Trump is not alone in protesting Chinese policies. In 2010 the Obama administration filed a complaint with the World Trade Organisation over IP disputes in the wind power industry. Various suits have been brought against China for failing to police IP law breaches. Be that as it may, at the 40th anniversary of the opening up of the

Chinese economy, President Xi proclaimed *"China will enter a new phase of opening up"*, pledging to increase imports, lower tariffs, improve market access and strengthen IP rights.

In a two-hour speech at the 2018 National People's Congress laying out China's economic priorities for 2018, Premier Li Keqiang discussed policies which western nations have criticised as benefitting Chinese companies at the expense of foreign competitors. Although the speech avoided direct references to the U.S., he discussed increasing protectionism globally and a requirement for China to protect its national interests. Regardless, the Premier outlined plans to continue opening up industries such as telecommunication, health care, education, and new-energy vehicles. This would be positive for western corporations in these fields, but pessimists have derided the moves, claiming China is relaxing restrictions now that it has stolen the necessary IP to compete on a level footing globally.

This *"opening up"* process has been slow and there are many reasons to expect it to continue. Prior to the nineteenth century, China was well cultivated, industrious and urbanised compared with the rest of the world. This began to change following the Great Depression which caused a collapse in international trade. After their victory in the Chinese Civil War the communists installed a planned economy at which point it began to stagnate. Chinese citizens saw no increase in living standards from 1957 through to the 1970s.

An economic strategy spearheaded by Chairman Mao Zedong known as the *"Great Leap Forward"* sought to introduce agricultural collectivisation to meet the Communist Party of China's socialist agenda. Beginning in 1958, private farming was banned and households were forced to join co-ops. The period that ensued saw a huge amount of investment and in many cases dramatic decreases in productivity, causing what became known as the *"Great Leap Forward Famine"* which killed between 30 and 50 million people.

After Deng Xiaoping took control of the Communist Party following Chairman Mao's death in 1976, he set in motion far-reaching reforms reversing many of the socialist policies established in the preceding three decades. Agriculture was decollectivised and land divided back into private plots. Similar steps were taken across a broad range of industries and the country was opened to foreign investment. Deng created special economic zones for foreign investment free from bureaucratic regulations and planning that hampered economic growth.

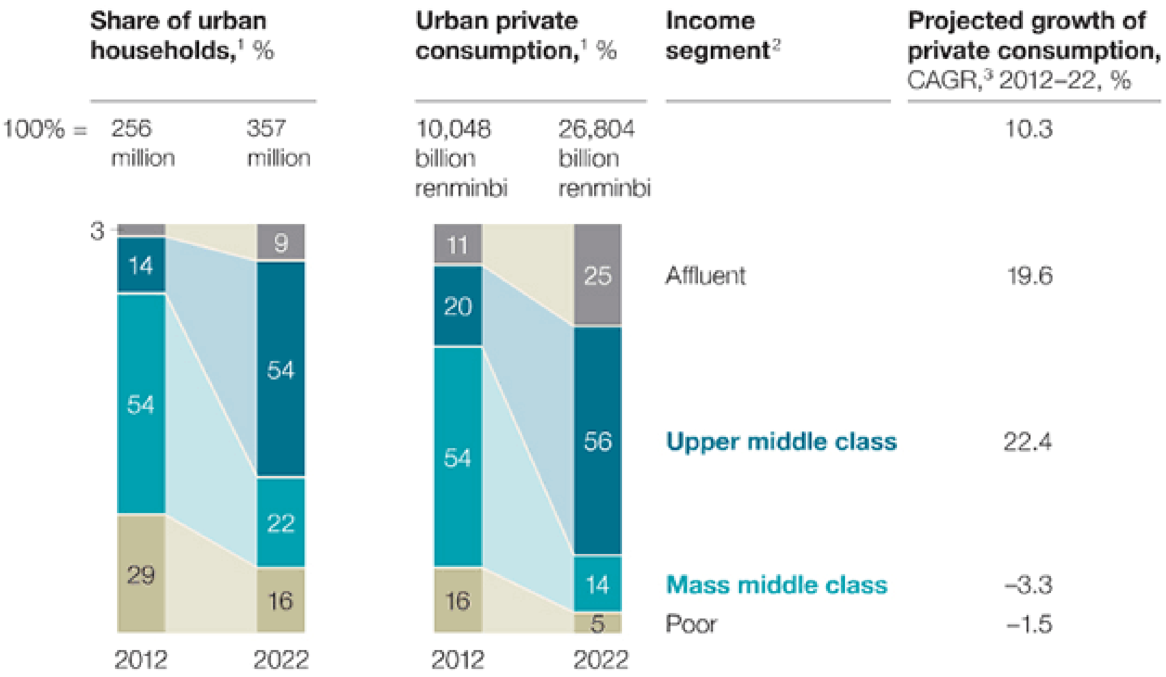
When Chinese protectionism is viewed through a historic lens, the slow pace of change is much more understandable. The Australian Federal Government struggled for many years to reduce automobile tariffs and government funding for domestic manufacture of cars, despite the lack of productivity the support fostered within the industry. Similar struggles are experienced the world over as nations seek to sign bilateral and multilateral free trade agreements with promises of lower trade barriers. Throughout its reform period, the overall tariff rate on goods imported to China has fallen from 56% to around 8% in 2016. Supply-side reforms such as the gradual removal of government support of State-Owed-Enterprises (SOEs) in the steel making industry have led to a far more rational market and rebounds in the profitability of steelmakers worldwide.

As far back as their independence from the British in the 1700s America sought to trade with China who put up barriers to those efforts. The Chinese insisted on payments in silver and limited trade with western nations to an area near Guangzhou city, now Hong Kong. Even then, U.S. traders struggled to find goods the Chinese were interested in buying. However, there was plenty of money for traders to make from selling Chinese products to U.S. consumers. To a certain extent, this struggle has continued to this day and could be view as the cause of the persistent trade deficit.

As long as the U.S. economy remains strong and its consumers demand goods manufactured overseas, it's difficult to see the U.S. successfully closing its trade deficit with the world, even if they manage to reduce their bilateral deficit with China. On the other hand, as the gross domestic product per capita of developing nations begins to catch up with that of developed nations over a more extended timeframe and consumption of those middle classes drives increased imports, it is much more realistic to expect some moderation in these trade deficits between developed and developing nations.

McKinsey & Company's analysis has forecast that by 2022, 54% of Chinese households will be classified as *"Upper middle class"* (earning between US$16,000 and US$34,000), up from 14% in 2012 as illustrated in ***Figure 16***. *"Mass middle class"* will shrink in percentage terms, but only 16% of households will be categorised as poor (earning less than $9,000), down from 29% in 2012. Combined with growth in the number of households from 256 million to 356 million, this shift can be expected to drive a huge increase in household consumption. Total household consumption in China has increased from RMB950b (US$114.5b) in 1990 to RMB29.3t (US$4.34t). The demographics at play in China will drive strong growth in consumption for many years to come.

Figure 17: China's middle class growth



¹Figures may not sum to 100%, because of rounding; data for 2022 are projected.
²Defined by annual disposable income per urban household, in 2010 real terms; affluent, >229,000 renminbi (equivalent to >$34,000); upper middle class, 106,000 to 229,000 renminbi (equivalent to $16,000 to $34,000); mass middle class, 60,000 to 106,000 renminbi (equivalent to $9,000 to $16,000); poor, <60,000 renminbi (equivalent to <$9,000).
³Compound annual growth rate.

Source: McKinsey & Company

It's clear that arguments can be made that China has trade policies which disadvantage international trade partners such as tariffs, foreign investment restrictions and a managed foreign currency mechanism. The issue with mounting an aggressive attack on China for its trade policies is that China is already more important to many countries, including the U.S., than those countries are to China.

As important as the U.S. economy is, China's place on the world stage has grown dramatically over the last two decades and it's growing middle class ensures that it will be the single most important economy in the world by the middle of the next decade. Those countries that develop strong trading relationships with China in the long term are certain to see strong growth in exports. ***SFM***

Migration and population trends

One of the more significant drivers of Australia's economic growth in recent years has been the positive effect of the annual permanent migration policy. To put this into some perspective, Australia's migrant intake in 2008 totalled 158,630 when the total population numbered 21.2 million. Over the past four years, the annual migrant intake has averaged 188,000 and the population has jumped to 24.8 million. Although the number of immigrants taken in each year has grown, as a percentage of the population it has remained constant at approximately 0.75%.

That said, a high intake has underpinned certain parts of the economy, including the property market. This is not a situation purely restricted to the Australian market, many other countries including New Zealand and Canada have had a similar experience. Numbers published for the 2017-2018 period revealed that the number of people accepted under the Department of Home Affairs migration program fell from 183,608 to 162,417 for the year, as set out in *Table 8* below.

Table 8: Australia's permanent immigration intake

Programme Year	Net migration numbers
2013 – 2014	190,000
2014 – 2015	189,097
2015 – 2016	189,770
2016 – 2017	183,608
2017 – 2018	162,417

Source: Department of Home Affairs

This is a sizable drop and warrants some caution. While Australia can expect to have positive net migration, the magnitude of the increase is expected to slow. In 2019 and 2020 population growth is expected to fall to around 1.35%. This would be the lowest rate of growth since 2005 and compares to the 1.5%-2.2% range experienced over the past decade.

Lower migration and population growth will likely lead to lower consumption growth across the economy. This could be seen in industries such as housing, hospitality and retail. While it will be hard to isolate the impact of these changes, immigration's contribution to overall economic growth is likely to slow. ***SFM***

Company visit diary June 2018 Quarter

April

Date	Company	Description
11-Apr	N/A	GMHBA Health Insurance MS Healthcare & Insurance Private Health Forum
11-Apr	N/A	Epworth HealthCare MS Healthcare & Insurance Private Health Forum
11-Apr	N/A	MediRecords MS Healthcare & Insurance Private Health Forum
11-Apr	N/A	HealtheCare MS Healthcare & Insurance Private Health Forum
11-Apr	NHF	NIB Holdings MS Healthcare & Insurance Private Health Forum
11-Apr	SGM	Sims Metal Management SFML Conference Call
12-Apr	SEK	SEEK SFML Management Meeting
12-Apr	SGR	The Star Entertainment Management Meeting & Sydney Site Visit
13-Apr	N/A	MessageMedia Group Macquarie IPO Management Meeting
17-Apr	WEB	Webjet GS Small & Mid-Cap Conference
17-Apr	ELO	Elmo Software GS Small & Mid-Cap Conference
18-Apr	HUB	HUB24 GS Small & Mid-Cap Conference
18-Apr	NEA	Nearmap GS Small & Mid-Cap Conference
18-Apr	ISU	iSelect GS Small & Mid-Cap Conference
18-Apr	IPH	IPH GS Small & Mid-Cap Conference
18-Apr	OSH	Oil Search Climate Change Resilience Report Conference Call
19-Apr	CPU	Computershare Investor Day
19-Apr	IPD	Impedimed PREVENT Trial Results Conference Call
19-Apr	N/A	MessageMedia Group SFML Management Meeting
23-Apr	N/A	MessageMedia Group SFML Management Meeting
23-Apr	MYO	MYOB Group SFML Conference Call
24-Apr	BKL	Blackmores Q3 FY18 Results Conference Call
26-Apr	IPD	Impedimed Q3 FY18 Results Conference Call
26-Apr	BKL	Blackmores Q3 FY18 Management Meeting
30-Apr	CSL	CSL Investor Day & Site Visit

May

Date	Company	Description
1-May	ALL	Aristocrat Leisure Investor Day
1-May	RMD	ResMed MS Management Meeting
1-May	N/A	Emerging Leaders Macquarie Meeting
1-May	NEA	Nearmap Macquarie Conference Presentation
1-May	OSH	Oil Search Macquarie Conference Presentation
1-May	SYD	Sydney Airport Macquarie Conference Presentation
1-May	BRG	Breville Macquarie Conference Presentation
1-May	WTC	Wisetech Global Macquarie Conference Presentation
2-May	ARB	ARB Corporation Macquarie Conference Presentation

Date	Company	Description
2-May	CSL	CSL Macquarie Conference Presentation
2-May	MPL	Medibank Private Macquarie Conference Presentation
2-May	NCK	Nick Scali Macquarie Conference Presentation
2-May	JBH	JB Hi-Fi Macquarie Conference Presentation
2-May	CGF	Challenger Macquarie Conference Presentation
2-May	ASG	Autosports Macquarie Conference Presentation
2-May	TCL	Transurban Macquarie Conference Presentation
2-May	BAP	Bapcor Macquarie Conference Presentation
2-May	MYO	MYOB Group Annual General Meeting
3-May	MYO	MYOB Group Macquarie Conference Presentation
3-May	3PL	3P Learning Macquarie Conference Presentation
3-May	SEK	SEEK Macquarie Conference Presentation
3-May	BKL	Blackmores Macquarie Conference Presentation
3-May	SUL	Super Ret Rep Macquarie Conference Presentation
3-May	CGL	The Citadel Macquarie Conference Presentation
3-May	CPU	Computershare Macquarie Conference Presentation
3-May	BKL	Blackmores SFML Management Meeting
4-May	WTC	Wisetech Global Investor Day
4-May	COH	Cochlear Investor Day
4-May	SYD	Sydney Airport Investor Day
7-May	REH	Reece Acquisition Conference Call
7-May	REH	Reece JP Morgan Acquisition Management Meeting
8-May	ALU	Altium Dassault Conference Call
10-May	IRE	IRESS Investor Strategy Briefing
10-May	N/A	Live Nation GS Management Meeting
15-May	N/A	MS Conference Call with John Glass
16-May	CPU	Computershare Acquisition Conference Call
17-May	TNE	Technology One Canberra Showcase
17-May	N/A	Scientific Games GS Conference Call
22-May	OFX	OFX Group FY18 Results Conference Call
22-May	JHX	James Hardie Industries Q4 FY18 Conference Call
22-May	TNE	Technology One HY18 Results Conference Call
22-May	OFX	OFX Group SFML Management Meeting
23-May	BKL	Blackmores Meet the Management at Warriewood
23-May	OFX	OFX Group DB Management Meeting
24-May	RWC	Reliance Worldwide Acquisition Conference Call
24-May	RWC	Reliance Worldwide JP Morgan Acquisition Management Meeting
24-May	ALL	Aristocrat Leisure HY18 Results Conference Call
24-May	RWC	Reliance Worldwide SFML Management Meeting
25-May	ALL	Aristocrat Leisure UBS Management Meeting
28-May	SGR	The Star Entertainment Investor Day & Site Visit

Date	Company	Description
28-May	FPH	Fisher & Paykel Healthcare FY18 Results Conference Call
28-May	TNE	Technology One UBS Conference Call
28-May	DMP	Domino Pizza Enterprise SFML Management Meeting
29-May	JHX	James Hardie Industries SFML Management Meeting
29-May	SGR	The Star Entertainment Macquarie Management Meeting
30-May	DMP	Domino Pizza Enterprise SFML Management Meeting
30-May	FPH	Fisher & Paykel Healthcare DB Management Meeting
30-May	FPH	Fisher & Paykel Healthcare SFML Management Meeting
31-May	MYO	MYOB Group SFML Conference Call
31-May	TNE	Technology One SFML Conference Call

June

Date	Company	Description
4-Jun	BKL	Blackmores Bungarribee Site Visit
6-Jun	CTD	Corp Travel MS Emerging Companies Conference
6-Jun	LOV	Lovisa Holdings MS Emerging Companies Conference
6-Jun	NWL	Netwealth Group MS Emerging Companies Conference
6-Jun	NEA	Nearmap MS Emerging Companies Conference
6-Jun	3PL	3P Learning MS Emerging Companies Conference
8-Jun	MYO	MYOB Group SFML Conference Call
14-Jun	IRE	IRESS GS Management Meeting
14-Jun	ALL	Aristocrat Leisure SFML Management Meeting
18-Jun	CLV	Clover Corporation UBS Management Meeting
25-Jun	N/A	MessageMedia Group Macquarie Management Meeting
27-Jun	TNE	Technology One SFML Conference Call
27-Jun	RWC	Reliance Worldwide SFML Conference Call
28-Jun	NEA	Nearmap UBS Conference Call